



# MNB Mountain National Bank

PROCESSED  
APR 21 2008  
THOMSON FINANCIAL

Received SEC  
APR 14 2008  
Washington, DC 20649



## Annual Report

December 31, 2007  
Mountain National Bancshares, Inc.

April 14, 2008

Fellow Shareholders,

I am pleased to report the results of operations for your company for the year ended December 31, 2007. We enjoyed yet another year of strong growth, with Total Assets reaching \$541 Million, an increase of 15.22% over 2006. Loans also grew by over \$52 Million to over \$397 Million, an increase of 15.37%. Deposits reached \$404 Million as of December 31, 2007, an increase of 11.79%. Net earnings for the company were \$3,912,094, an increase over 2006.

We have been very pleased with our continued growth, and are excited with the prospects for the new year ahead. 2007 saw continued expansion of our banking franchise, with the opening of our first of three full service bank offices in Maryville, Tennessee, the county seat of Blount County. Our second office in Maryville is scheduled to open this week, and the third office is now under construction with completion slated for early 2009. Once these offices are open, and with the opening of additional locations in Sevier County, we will have 12 banking offices open by mid year 2009. We appreciate and value your support of these offices and of our efforts.



*Dwight B. Grizzell, President and Chief Executive Officer and  
Charlie R. Johnson, Chairman of the Board*

In many ways, 2008 will be one of our most challenging years. Pressure on earnings is high, especially given the recent drop in interest rates spurred by the Federal Reserve, which has resulted in a decrease of 200 basis points in less than 60 days. This sudden reduction in loan rates caught all bankers by surprise, and we are still making adjustments to our balance sheet to better fit the environment. The expenses brought about by the construction of new offices also impacts earnings in the short run, but these investments in buildings and people will result in greater income in the years to come. The economic downturn felt in most of the country will no doubt be felt locally, although this area has been remarkably resilient to recessions, but it is hoped that the effect will be milder here than elsewhere. We are encouraged by the continued strength of our loan portfolio, where delinquency rates are still among the lowest in the industry and are a testament to our lending officers and the oversight of our dedicated board of directors. Our strong investment portfolio also contributes to earnings and serves as a source of liquidity for the institution.

Now three months into 2008, we are confident that we have the best staff and the most attractive and convenient facilities in every area that we serve. Our goal is to be the premier provider of banking services and we invite you to take advantage of our banking products and dedicated staff if you have not already done so.

I wish you continued success and health in 2008. Thank you for your continued support, and if we may be of further service, please stop by and see us.

Yours truly,

Dwight B. Grizzell  
President and Chief Executive Officer

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2007

or

TRANSITION REPORT UNDER SECTION 13 or 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-49912

**MOUNTAIN NATIONAL BANCSHARES, INC.**  
(Exact name of registrant as specified in its charter)

Tennessee  
(State or other jurisdiction  
of incorporation or organization)

75-3036312  
(I.R.S. Employer Identification No.)

300 East Main, Sevierville, Tennessee  
(Address of principal executive offices)

37862  
(Zip code)

(865) 428-7990  
(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act: None

Securities registered under Section 12(g) of the Exchange Act:

Common Stock, \$1.00 par value

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

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No [ ]

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

SEC  
Mail Processing  
Section  
APR 14 2008  
Washington, DC  
101

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. (Check one):

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

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

Yes  No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$60,948,149.

There were 2,503,224 shares of Common Stock outstanding as of February 29, 2008.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive Proxy Statement for the 2008 Annual Meeting of Shareholders (the "2008 Proxy Statement") are incorporated by reference into Part III of this Report. Other than those portions of the 2008 Proxy Statement specifically incorporated by reference herein pursuant to Part III, no other portions of the 2008 Proxy Statement shall be deemed so incorporated.

**MOUNTAIN NATIONAL BANCSHARES, INC.**  
**Annual Report on Form 10-K**  
**For the Fiscal Year Ended December 31, 2007**

**Table of Contents**

<b><u>Item Number</u></b>		<b><u>Page Number</u></b>
<b>Part I</b>		
1.	Business.....	1
1A.	Risk Factors.....	19
2.	Properties.....	23
3.	Legal Proceedings .....	24
4.	Submission of Matters to a Vote of Security Holders .....	24
<b>Part II</b>		
5.	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.....	24
7.	Management’s Discussion and Analysis of Financial Condition and Results of Operation .....	26
8.	Financial Statements and Supplementary Data .....	54
9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure .....	54
9A(T).	Controls and Procedures.....	54
9B.	Other Information.....	55
<b>Part III</b>		
10.	Directors, Executive Officers and Corporate Governance.....	55
11.	Executive Compensation.....	55

12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters .....	55
13.	Certain Relationships and Related Transactions, and Director Independence .....	56
14.	Principal Accountant Fees and Services .....	56

**Part IV**

15.	Exhibits and Financial Statement Schedules.....	56
	Signatures .....	59

## **PART I**

### **ITEM 1. BUSINESS**

#### **Forward-Looking Statements**

Certain of the statements made herein under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operation," and elsewhere, including information incorporated herein by reference to other documents, are "forward-looking statements" within the meaning and subject to the protections of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions, and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause the actual results, performance or achievements of Mountain National Bancshares, Inc. ("Mountain National" or the "Company") to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as "may," "will," "anticipate," "assume," "should," "indicate," "seek," "attempt," "would," "believe," "contemplate," "expect," "estimate," "continue," "plan," "point to," "project," "could," "intend," "target" and other similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation, those set forth in Item 1A. Risk Factors below and the following factors:

- the effects of future economic or business conditions;
- governmental monetary and fiscal policies, as well as legislative and regulatory changes, including changes in banking, securities and tax laws and regulations;
- the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values of loan collateral, securities and interest sensitive assets and liabilities;
- credit risks of borrowers;
- the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;
- the failure of assumptions underlying the establishment of reserves for possible loan losses and other estimates;
- the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and the possible failure to achieve expected gains, revenue growth and/or expense savings from such transactions;

- changes in accounting policies, rules and practices;
- changes in technology or products that may be more difficult, or costly, or less effective, than anticipated;
- the effects of war or other conflict, acts of terrorism or other catastrophic events that may affect general economic conditions; and
- other factors and risks described in any of our subsequent reports that we make with the Securities and Exchange Commission (the "Commission") under the Exchange Act.

All written or oral forward-looking statements that are made by or are attributable to us are expressly qualified in their entirety by this cautionary notice. Except as required by the federal securities laws we do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made.

### **The Company**

Mountain National is a bank holding company registered with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, as amended. The Company provides a full range of banking services through its banking subsidiary, Mountain National Bank (the "Bank").

For the purposes of the discussions in this report, the words "we," "us," and "our" refer to the combined entities of the Company and the Bank unless otherwise indicated or evident. The Company's main office is located at 300 East Main Street, Sevierville, Tennessee 37862. The Company was incorporated as a business corporation in March 2003 under the laws of the State of Tennessee for the purpose of acquiring 100% of the issued and outstanding shares of common stock of the Bank. Effective July 1, 2002, the Company and the Bank entered into a reorganization pursuant to which the Company acquired 100% of the outstanding shares of the Bank and the shareholders of the Bank became the shareholders of the Company. In June 2003, the Company received approval from the Federal Reserve Bank of Atlanta to become a bank holding company.

At December 31, 2007, the assets of the Company consisted primarily of its ownership of the capital stock of the Bank.

The Company is authorized to engage in any activity permitted by law to a corporation, subject to applicable federal and state regulatory restrictions on the activities of bank holding companies. The Company's holding company structure provides it with greater flexibility than the Bank would otherwise have relative to expanding and diversifying its business activities through newly formed subsidiaries or through acquisitions. While management of the Company has no present plans to engage in any other business activities, management may from time to time study the feasibility of establishing or acquiring subsidiaries to engage in other business activities to the extent permitted by law.

## **The Bank**

The Bank is organized as a national banking association. The Bank applied to the Office of the Comptroller of the Currency (the "OCC"), and the Federal Deposit Insurance Corporation, (the "FDIC"), on February 16, 1998, to become an insured national banking association. The Bank received approval from the OCC to organize as a national banking association on June 16, 1998 and commenced business on November 23, 1998. The Bank's principal business is to accept demand and savings deposits from the general public and to make residential mortgage, commercial and consumer loans.

## **Our Banking Business**

General. Our banking business consists primarily of traditional commercial banking operations, including taking deposits and originating loans. We conduct our banking activities from our main office located in Sevierville, Tennessee and through six additional branch offices in Sevier County, Tennessee, and one branch office in Blount County, Tennessee. We operate two branch offices in Gatlinburg, two branch offices in Pigeon Forge, a branch office in Seymour, a branch office in Kodak, all in Sevier County, and a branch office that we opened during October 2007 in Maryville, Blount County, Tennessee. The retail nature of our commercial banking operations allows for diversification in the number of our depositors and borrowers, and we do not believe that we are dependent on a single or a few customers.

We offer a variety of retail banking services. We seek savings and other time and demand deposits from consumers and businesses in our primary market area by offering a full range of deposit accounts, including savings, demand deposit, retirement, including individual retirement accounts, or "IRA's," and professional and checking accounts, as well as certificates of deposit. We use the deposit funds we receive to originate mortgage, commercial and consumer loans, and to make other authorized investments. In addition, we currently maintain 17 full-service ATMs throughout our market area. Because the Bank is a member of a number of payment systems networks, Bank customers may also access banking services through ATMs and point of sale terminals throughout the world. In addition to traditional deposit-taking and lending services, we also provide a variety of checking accounts, savings programs, night depository services, safe deposit facilities and credit card plans.

The banking industry is significantly affected by prevailing economic conditions, as well as government policies and regulations concerning, among other things, monetary and fiscal affairs, the housing industry and financial institutions. Deposits at commercial banks are influenced by economic conditions, including interest rates and competing investment instruments, levels of personal income and savings, among others. Lending activities are also influenced by a number of economic factors, including demand for and supply of housing, conditions in the construction industry, local economic and seasonal factors and availability of funds. Our primary sources of funding for lending activities include savings and demand deposits, income from investments, loan principal payments and borrowings. For additional information relating to our deposits and loans, refer to "Management's Discussion and Analysis of Financial Condition and Results of Operation."

Market Areas. Our primary market areas are Sevier and Blount Counties, contiguous counties located in eastern Tennessee. We intend to continue our focus on these primary market areas in the future. Additionally, even with our current market area focus, some of our business may come from other areas contiguous to our primary market area.

### Lending Activities

General. We concentrate on developing a diversified loan portfolio consisting of first mortgage loans secured by residential properties, loans secured by commercial properties and other commercial and consumer loans.

Real Estate Lending. We originate permanent and construction loans having terms in the case of the permanent loans of up to 30 years that are typically secured by residential real estate comprised of single-family dwellings and multi-family dwellings of up to four units. All of our residential real estate loans consist of conventional loans that are not insured or guaranteed by government agencies. We also originate and hold in our portfolio traditional fixed-rate mortgage loans in appropriate circumstances.

Consumer Lending. We originate consumer loans that typically fall into the following categories:

- loans secured by junior liens on real estate, including home improvement and home equity loans, which have an average maturity of about three years and generally are limited to 80% of appraised value;
- loans secured by personal property, such as automobiles, recreational vehicles or boats, which typically have 36 to 60 month maturities;
- loans to our depositors secured by their time deposit accounts or certificates of deposit;
- unsecured personal loans and personal lines of credit; and
- credit card loans.

Consumer loans generally entail greater risk than residential mortgage loans, particularly in the case of consumer loans that are unsecured or that are secured by rapidly depreciating assets such as automobiles. Where consumer loans are unsecured or secured by depreciating assets, the absence of collateral or the insufficiency of any repossessed collateral to serve as an adequate source of repayment of the outstanding loan balance poses greater risk of loss to us. When a deficiency exists between the outstanding balance of a defaulted loan and the value of collateral repossessed, the borrower's financial instability and life situations that led to the default (which may include job loss, divorce, illness or personal bankruptcy, among other things) often does not warrant substantial further collection efforts. Furthermore, the application of various federal and state laws, including federal bankruptcy and state insolvency laws, may limit the amount that we can recover in the event a consumer defaults on an unsecured or undersecured loan.

Construction Lending. We offer single-family residential construction loans to borrowers for construction of one-to-four family residences in our primary market area. Generally, we limit our construction lending to construction-permanent loans and make these loans to individuals

building their primary residences. We also originate construction loans to selected local builders for construction of single-family dwellings.

Our construction loans may have fixed or adjustable interest rates and are underwritten in accordance with the same standards that we apply to permanent mortgage loans, with the exception that our construction loans generally provide for disbursement of the loan amount in stages during a construction period of up to 12 months, during which period the borrower is required to make monthly payments of accrued interest on the outstanding loan balance. We typically require a maximum loan-to-value ratio of 80% on construction loans we originate. While our construction loans generally convert to permanent loans following construction, the construction loans we extend to builders generally require repayment in full upon the completion of construction, or, alternatively, may be assumed by the borrower.

Construction lending affords us the opportunity to earn higher interest rates and fees with shorter terms to maturity than does single-family permanent mortgage lending. Construction lending, however, is generally considered to involve a higher degree of risk than single-family permanent mortgage lending because of the inherent difficulty in estimating both a property's value at completion of the project and the projected cost of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to complete the project. If the estimate of value upon completion proves inaccurate, we may be confronted at, or prior to, the maturity of the loan with collateral of insufficient value to assure full repayment. Construction projects may also be jeopardized by downturns in the economy or demand in the area where the project is being undertaken, disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the builder's ability to repay the loan is often dependent on the builder's ability to sell the property prior to the time the construction loan becomes due. We seek to address these risks by adhering to underwriting policies and disbursement procedures designed to limit the risk and by monitoring the construction project.

Commercial Lending. We originate secured and unsecured loans for commercial, corporate, business and agricultural purposes, and we engage in commercial real estate activities consisting of loans for hotels, motels, restaurants, retail store outlets and service providers such as insurance agencies. Currently, we concentrate our commercial lending efforts on originating loans to small businesses for purposes of providing working capital, capital improvements, and construction and leasehold improvements. These loans typically have one-year maturities, if they are unsecured loans, or, in the case of small business loans secured by real estate, have an average maturity of five years. We also participate in the Small Business Administration's guaranteed commercial loan program.

Commercial lending, while generally considered to involve a higher degree of credit risk than long-term financing of residential properties, generally provides higher yields and greater interest rate sensitivity than do residential mortgage loans. Commercial loans are generally adjustable rate loans or loans that have short-term maturities of one to three years. The higher risks inherent in commercial lending include risks specific to the business venture, delays in leasing the collateral and excessive collateral dependency, vacancy, delays in obtaining or inability to obtain permanent financing and difficulties we may experience in exerting influence over or acquiring the collateral following a borrower's default. Moreover, commercial loans

often carry larger loan balances to single borrowers or groups of related borrowers than do residential real estate loans. With respect to commercial real estate lending, the borrower's ability to make principal and interest payments on loans secured by income-producing properties is typically dependent on the successful operation of the related real estate project and thus may be subject to a greater extent to adverse conditions in the real estate market or in the economy generally. We attempt to mitigate the risks inherent in commercial lending by, among other things, securing our loans with adequate collateral and extending commercial loans only to persons located in our primary market area.

Creditworthiness and Collateral. We require each prospective borrower to complete a detailed loan application which we use to evaluate the applicant's creditworthiness. All loan applications are reviewed and approved or disapproved in accordance with guidelines established by the Bank's Board of Directors. We also require that loan collateral be appraised by an in house evaluation or by independent appraisers approved by the Bank's Board of Directors and require borrowers to maintain fire and casualty insurance on collateral in accordance with guidelines established by the Bank's Board of Directors. Title insurance is required for most real property collateral.

Loan Originations. We originate loans primarily for our own portfolio but, subject to market conditions, we may sell certain loans we originate in the secondary market. Initially, most of our loans are originated based on referrals and to walk-in customers. We also use various methods of local advertising to stimulate originations.

Secondary Market Activities. We engage in secondary mortgage market activities, principally the sale of certain residential mortgage loans on a servicing released basis, subject to market conditions. Secondary mortgage market activities permit us to generate fee income and sale income to supplement our principal source of income - net interest income resulting from the interest margin between the yield on interest-earning assets like loans and investment securities and the interest paid on interest-bearing liabilities such as savings deposits, time deposit certificates and funds borrowed by the Bank.

From time to time we originate a limited number of permanent, conventional residential mortgage loans that we sell on a servicing-released basis to private institutional investors such as savings institutions, banks, life insurance companies and pension funds. We originate these loans on terms and conditions similar to those required for sale to the Federal Home Loan Mortgage Corporation ("FHLMC"), and the Federal National Mortgage Association ("FNMA"), except that we occasionally offer these loans with higher dollar limits than are permissible for FHLMC or FNMA-eligible loans.

The loan-to-value ratios we require for the residential mortgage loans we originate are determined based on guidelines established by the Bank's Board of Directors pursuant to applicable law.

Income from Lending Activities. Our lending activities generate interest and loan origination fee income. Loan origination fees are calculated as a percentage of the principal amount of the mortgage loans we originate and are charged to the borrower by the Bank for originating the loan. We also receive loan fees and charges related to existing loans, which include late charges and assumption fees.

**Loan Delinquencies and Defaults.** When a borrower fails to make a required loan payment for 30 days, we classify the loan as delinquent. If the delinquency exceeds 90 days and is not cured through the Bank's normal collection procedures, we institute more formal recovery efforts. If a foreclosure action is initiated and the loan is not reinstated, paid in full or refinanced, the property is sold at a judicial or trustee sale at which, in some instances, the Bank acquires the property. Thereafter, such acquired property is recorded in the Bank's records as "other real estate owned" until the property is sold. In some cases, we may finance sales of other real estate owned, which may involve our origination of "loans to facilitate" that typically involve a lower down payment or a longer term.

### **Investment Activities**

Our investment securities portfolio is an integral part of our total assets and liabilities management strategy. We use our investments, in part, to further our interest rate risk management objective of reducing our sensitivity to interest-rate fluctuations. Our primary objective in making investment determinations with respect to our securities portfolio is to achieve a high degree of maturity and rate matching between these assets and our interest-bearing liabilities. In order to achieve this goal, we concentrate our investments, which constituted approximately 15.3% of our total assets at December 31, 2007, in U.S. government securities or other securities of similar low risk. The U.S. government and other investment-grade securities in which we invest typically have maturities ranging from 30 days to 30 years.

### **Sources of Funds**

**General.** Deposits are the primary source of funds we use to support our lending activities and other general business activities. Other sources of funds include loan repayments, loan sales and borrowings. Although deposit activity is significantly influenced by fluctuations in interest rates and general market conditions, loan repayments are a relatively stable source of funds. We also use short-term borrowings to compensate in periods where our normal funding sources are insufficient to satisfy our funding needs. We use long-term borrowings to support extended activities and to extend the term of our liabilities.

**Deposits.** We offer a variety of programs designed to attract both short-term and long-term deposits from the general public in our market areas. These programs include savings accounts, NOW accounts, demand deposit accounts, money market deposit accounts, fixed-rate and variable-rate certificate of deposit accounts of varying maturities, retirement accounts and certain other accounts. We particularly focus on promoting long-term deposits, such as IRA accounts and certificates of deposit. Additionally, we use brokered deposits that are comparable to our traditional certificates of deposit.

**Borrowings.** The Bank became a member of the Federal Home Loan Bank of Cincinnati (the "FHLB of Cincinnati") in December 2001. The FHLB of Cincinnati functions as a central reserve bank that provides credit for member institutions. As a member, the Bank is required to own capital stock in the FHLB of Cincinnati. Membership in the FHLB of Cincinnati entitles the Bank, provided certain standards related to creditworthiness have been met, to apply for advances on the security of the FHLB of Cincinnati stock it holds as well as on the security of certain of its residential mortgage loans, commercial loans and other assets (principally, its investment

securities that are obligations of, or guaranteed by, the United States). The FHLB of Cincinnati makes advances to the Bank pursuant to several different credit programs. Each credit program has its own interest rate and range of maturities. Interest rates on FHLB of Cincinnati advances are generally variable and adjust to reflect actual conditions existing in the credit markets. The uses for which we may employ funds received pursuant to FHLB of Cincinnati advances are prescribed by the various lending programs, which also prescribe borrowing limitations. Acceptable uses prescribed by the FHLB of Cincinnati have included expansion of residential mortgage lending and funding short-term liquidity needs. Depending on the particular credit program under which we borrow, borrowing limitations are generally based on the FHLB of Cincinnati's assessment of our creditworthiness. The FHLB of Cincinnati is required to review the credit limitations and standards to which we are subject at least once every six months.

Financing. In August of 1998, the Bank completed an offering of common stock which yielded proceeds of \$12,000,000. On November 7, 2003, the Company completed the sale, through its wholly owned statutory trust subsidiary, MNB Capital Trust I, of \$5,500,000 of trust preferred securities, which we refer to as "Capital Securities I," which mature on December 31, 2033, and have a liquidation amount of \$50,000 per Capital Security. Interest on the Capital Securities I is to be paid quarterly on the last day of each March, June, September and December and is reset quarterly based on the three-month LIBOR plus 305 basis points. The Company used the net proceeds from the offering of Capital Securities I to pay off an outstanding line of credit.

On June 20, 2006, the Company completed the sale, through its wholly owned statutory trust subsidiary, MNB Capital Trust II, of \$7,500,000 of trust preferred securities, which we refer to as "Capital Securities II," which mature on July 7, 2036, and have a liquidation amount of \$1,000 per Capital Security. Interest on the Capital Securities II is to be paid quarterly on the seventh day of each January, April, July and October and is reset quarterly based on the three-month LIBOR plus 160 basis points. The Company used the net proceeds from the offering of Capital Securities II to increase regulatory capital for the Company and for operating funds for the Bank.

During the third quarter of 2005, the Company sold 416,500 shares of common stock. This sale resulted in an increase in common stock and surplus of approximately \$9,896,500. In connection with the offering, there were 416,500 warrants issued, one warrant for each share of stock sold, that had an exercise price of \$25.20 per warrant. The warrants could be exercised beginning after one year from the date of the sale of the common stock, and had to be exercised no later than two years from the date of the sale. The final day to exercise the common stock warrants was September 7, 2007. During the period in which they could be exercised, 476,194 out of 482,151 (adjusted for 5% stock dividends) warrants were exercised at a weighted average exercise price of \$21.77 (adjusted for 5% stock dividends). The total corresponding increase to shareholders' equity from the conversion of the stock warrants to common stock from September 7, 2006 to September 7, 2007, the period the warrants could be exercised, was approximately \$10,367,000.

## **Competition**

We face significant competition in our primary market areas from a number of sources, including eight commercial banks and one savings institution in Sevier County and eleven commercial banks and one savings institution in Blount County. As of June 30, 2007, there were 50 commercial bank branches and three savings institutions branches located in Sevier County and 44 commercial bank branches and one savings institution branch located in Blount County.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and other recent federal and state laws have resulted in increased competition from both conventional banking institutions and other businesses offering financial services and products. Mortgage banking firms, finance companies, real estate investment trusts, insurance companies, leasing companies, factors and certain government agencies provide additional competition for loans and for certain financial services. We also compete for deposit accounts with a number of other financial intermediaries, including securities brokerage firms, money market mutual funds, government and corporate securities and credit unions. The primary criteria on which institutions compete for deposits and loans are interest rates, loan origination fees and range of services offered.

Most of our competitors have been in existence for a longer period of time, are better established, have substantially greater financial resources and have more extensive facilities than we do. Because of the size and established presence of our competitors in our market area, these competitors have longer-term customer relationships than we maintain and are able to offer a wider range of services than we offer.

As evidenced by our deposit and loan growth, as described in "Management's Discussion and Analysis of Financial Condition and Results of Operation," we have been able to compete with our larger, more established competitors by attracting customers from existing financial institutions as well as from growth in our communities by focusing on providing a high level of customer service and by providing the products most important to our customers. During our relatively short operating history, we have been successful in hiring a staff with significant local bank experience that shares our commitment to providing our customers with the highest levels of customer service. While focusing on customer service, we are also able to offer our customers most of the banking services offered by our local competitors, including Internet banking, investment services and sweep accounts.

## **Employees**

We currently employ a total of 176 employees, including 172 full time employees. We are not a party to any collective bargaining agreements with our employees, and we consider relations with our employees to be good.

## **Seasonality**

Due to the predominance of the tourism industry in Sevier County, a significant portion of our commercial loan portfolio is concentrated within that industry. The predominance of the tourism industry also makes our business more seasonal in nature than may be the case with banks and financial institutions in other market areas. Deposit growth generally slows during the

first quarter each year and then increases during each of the last three quarters. Our cost of funds tends to increase during the first quarter each year due to our dependence on borrowed funds that typically have a higher interest rate than our core deposits. Growth in the tourism industry in Sevier County has remained strong during recent years and we anticipate that this trend will continue.

## **Supervision and Regulation**

### **Supervision and Regulation**

Bank holding companies and banks are extensively regulated under federal and state law. This discussion is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below and is not intended to be a complete description of the statutes or regulations applicable to the Company's and the Bank's business. Supervision, regulation, and examination of the Company and the Bank and their respective subsidiaries by the bank regulatory agencies are intended primarily for the protection of bank depositors rather than holders of Company capital stock. Any change in applicable law or regulation may have a material effect on the Company's business.

### **Bank Holding Company Regulation**

The Company, as a bank holding company, is subject to supervision and regulation by the Board of Governors of the Federal Reserve System ("Federal Reserve") under the BHC Act. Bank holding companies are generally limited to the business of banking, managing or controlling banks, and other activities that the Federal Reserve determines to be so closely related to banking, or managing or controlling banks, as to be a proper incident thereto. The Company is required to file with the Federal Reserve periodic reports and such other information as the Federal Reserve may request. The Federal Reserve examines the Company, and may examine non-bank subsidiaries the Company may acquire.

The BHC Act requires prior Federal Reserve approval for, among other things, the acquisition by a bank holding company of direct or indirect ownership or control of more than 5% of the voting shares or substantially all the assets of any bank, or for a merger or consolidation of a bank holding company with another bank holding company. With certain exceptions, the BHC Act prohibits a bank holding company from acquiring direct or indirect ownership or control of voting shares of any company which is not a bank or bank holding company, and from engaging directly or indirectly in any activity other than banking or managing or controlling banks or performing services for its authorized subsidiaries. A bank holding company, may, however, engage in or acquire an interest in a company that engages in activities which the Federal Reserve has determined by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

The Gramm-Leach-Bliley Act of 1999 (the "GLB Act") substantially revised the statutory restrictions separating banking activities from certain other financial activities. Under the GLB Act, bank holding companies that are "well-capitalized" and "well-managed", as defined in Federal Reserve Regulation Y, which have and maintain "satisfactory" Community Reinvestment Act ("CRA") ratings, and meet certain other conditions, can elect to become "financial holding companies". Financial holding companies and their subsidiaries are permitted

to acquire or engage in previously impermissible activities such as insurance underwriting, securities underwriting, travel agency activities, broad insurance agency activities, merchant banking, and other activities that the Federal Reserve determines to be financial in nature or complementary thereto. In addition, under the merchant banking authority added by the GLB Act and Federal Reserve regulation, financial holding companies are authorized to invest in companies that engage in activities that are not financial in nature, as long as the financial holding company makes its investment with the intention of limiting the term of its investment and does not manage the company on a day-to-day basis, and the invested company does not cross-market with any of the financial holding company's controlled depository institutions. Financial holding companies continue to be subject to the overall oversight and supervision of the Federal Reserve, but the GLB Act applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. While the Company has no present plans to become a financial holding company, it may elect to do so in the future in order to exercise the broader activity powers provided by the GLB Act. The GLB Act also includes consumer privacy provisions, and the federal bank regulatory agencies have adopted extensive privacy rules implementing the GLB Act.

The Company is a legal entity separate and distinct from the Bank. Various legal limitations restrict the Bank from lending or otherwise supplying funds to the Company. The Company and the Bank are subject to Section 23A of the Federal Reserve Act and Federal Reserve Regulation W thereunder. Section 23A defines "covered transactions", which include extensions of credit, and limits a bank's covered transactions with any affiliate to 10% of such bank's capital and surplus. All covered and exempt transactions between a bank and its affiliates must be on terms and conditions consistent with safe and sound banking practices, and banks and their subsidiaries are prohibited from purchasing low-quality assets from the bank's affiliates. Finally, Section 23A requires that all of a bank's extensions of credit to its affiliates be appropriately secured by acceptable collateral, generally United States government or agency securities. The Company and the Bank also are subject to Section 23B of the Federal Reserve Act, which generally limits covered and other transactions among affiliates to be on terms, including credit standards, that are substantially the same or at least as favorable to the bank or its subsidiary as those prevailing at the time for similar transactions with unaffiliated companies.

The BHC Act permits acquisitions of banks by bank holding companies, such that Mountain National and any other bank holding company located in Tennessee may now acquire a bank located in any other state, and any bank holding company located outside Tennessee may lawfully acquire any bank based in another state, subject to certain deposit-percentage, age of bank charter requirements, and other restrictions. Federal law also permits national and state-chartered banks to branch interstate through acquisitions of banks in other states. Under Tennessee law, in order for an out-of-state bank or bank holding company to establish a branch in Tennessee, the bank or bank holding company must purchase an existing bank, bank holding company, or branch of a bank in Tennessee which has been in existence for at least three years. *De novo* interstate branching is permitted under Tennessee law on a reciprocal basis. The Bank is eligible to be acquired by any bank or bank holding company, whether inter-or intrastate, since it has now been in existence for three years.

Federal Reserve policy requires a bank holding company to act as a source of financial strength and to take measures to preserve and protect bank subsidiaries in situations where

additional investments in a troubled bank may not otherwise be warranted. In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), where a bank holding company has more than one bank or thrift subsidiary, each of the bank holding company's subsidiary depository institutions are responsible for any losses to the FDIC as a result of an affiliated depository institution's failure. As a result, a bank holding company may be required to loan money to its subsidiaries in the form of capital notes or other instruments that qualify as capital under regulatory rules. However, any loans from the holding company to such subsidiary banks likely will be unsecured and subordinated to such bank's depositors and perhaps to other creditors of the bank.

### Bank Regulation

The Bank is subject to supervision, regulation, and examination by the OCC which monitors all areas of the operations of the Bank, including reserves, loans, mortgages, issuances of securities, payment of dividends, establishment of branches, capital adequacy, and compliance with laws. The Bank is a member of the FDIC and, as such, its deposits are insured by the FDIC to the maximum extent provided by law. See "FDIC Insurance Assessments".

While the OCC has authority to approve branch applications, national banks are required by the National Bank Act to adhere to branching laws applicable to state chartered banks in the states in which they are located. With prior regulatory approval, Tennessee law permits banks based in the state to either establish new or acquire existing branch offices throughout Tennessee and in other states on a reciprocal basis. Mountain National and any other national or state-chartered bank generally may branch across state lines by merging with banks in other states if allowed by the applicable states' laws. Tennessee law, with limited exceptions, currently permits branching across state lines either through interstate merger or branch acquisition. Tennessee, however, only permits an out-of-state bank, short of an interstate merger, to branch into Tennessee through branch acquisition if the home state of the out-of-state bank permits Tennessee-based banks to acquire branches there.

The OCC has adopted a series of revisions to its regulations, including expanding the powers exercisable by operating subsidiaries of the Bank. These changes also modernize and streamline corporate governance, investment and fiduciary powers. The OCC also has the ability to preempt state laws purporting to regulate the activities of national banks.

The OCC has adopted the Federal Financial Institutions Examination Council's ("FFIEC") rating system and assigns each financial institution a confidential composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations including Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to market risk, as well as the quality of risk management practices. For most institutions, the FFIEC has indicated that market risk primarily reflects exposures to changes in interest rates. When regulators evaluate this component, consideration is expected to be given to: (i) management's ability to identify, measure, monitor, and control market risk; (ii) the institution's size; (iii) the nature and complexity of its activities and its risk profile; and (iv) the adequacy of its capital and earnings in relation to its level of market risk exposure. Market risk is rated based upon, but not limited to, an assessment of the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices; management's ability to identify,

measure, monitor, and control exposure to market risk; and the nature and complexity of interest rate risk exposure arising from nontrading positions.

The GLB Act requires banks and their affiliated companies to adopt and disclose privacy policies regarding the sharing of personal information they obtain from their customers with third parties. GLB also permits bank subsidiaries to engage in "financial activities" through subsidiaries similar to those permitted to financial holding companies. See the discussion regarding GLB in "Bank Holding Company Regulation" above.

### Community Reinvestment Act

The Company and the Bank are subject to the CRA and the federal banking agencies' regulations. Under the CRA, all banks and thrifts have a continuing and affirmative obligation, consistent with their safe and sound operation to help meet the credit needs for their entire communities, including low and moderate income neighborhoods. The CRA requires a depository institution's primary federal regulator, in connection with its examination of the institution, to assess the institution's record of assessing and meeting the credit needs of the communities served by that institution, including low- and moderate-income neighborhoods. The regulatory agency's assessment of the institution's record is made available to the public. Further, such assessment is required of any institution which has applied to: (i) charter a national bank; (ii) obtain deposit insurance coverage for a newly-chartered institution; (iii) establish a new branch office that accepts deposits; (iv) relocate an office; (v) merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution, or (vi) expand other activities, including engaging in financial services activities authorized by the GLB Act. A less than satisfactory CRA rating will slow, if not preclude, expansion of banking activities and prevent a company from becoming a financial holding company. The Bank has a satisfactory CRA rating.

The GLB Act and federal bank regulations have made various changes to the CRA. Among other changes, CRA agreements with private parties must be disclosed and annual CRA reports must be made to a bank's primary federal regulator. A bank holding company will not be permitted to become or remain a financial holding company and no new activities authorized under the GLB Act may be commenced by a holding company or by a bank financial subsidiary if any of its bank subsidiaries received less than a "satisfactory" CRA rating in its latest CRA examination. The OCC and other federal bank regulators have revised their CRA regulations. The Bank has grown from small bank status to the newly created intermediate small bank status. The requirements for an intermediate small bank to meet its CRA objectives are more stringent than those for a small bank, but less so than those for large banks.

The Bank is also subject to, among other things, the provisions of the Equal Credit Opportunity Act (the "ECOA") and the Fair Housing Act (the "FHA"), both of which prohibit discrimination based on race or color, religion, national origin, sex, and familial status in any aspect of a consumer or commercial credit or residential real estate transaction. In 1994, the Department of Housing and Urban Development, the Department of Justice (the "DOJ"), and the federal banking agencies issued an Interagency Policy Statement on Discrimination in Lending in order to provide guidance to financial institutions in determining whether discrimination exists, how the agencies will respond to lending discrimination, and what steps lenders might

take to prevent discriminatory lending practices. The DOJ has also increased its efforts to prosecute what it regards as violations of the ECOA and FHA.

### Sarbanes-Oxley Act

We are required to comply with various corporate governance and financial reporting requirements under the Sarbanes-Oxley Act of 2002, as well as rules and regulations adopted by the SEC and the Public Company Accounting Oversight Board thereunder. In particular, we are required to include management reports on internal controls as part of our annual report for the year ended December 31, 2007, pursuant to Section 404 of the Sarbanes-Oxley Act. We have spent significant amounts of time and money on compliance with these rules and anticipate a similar burden going forward. We completed our assessment of our internal controls in a timely manner and management's report on internal controls is included in Item 9A(T) of this report. Our failure to comply with these internal control rules may materially adversely affect our reputation, our ability to obtain the necessary certifications to our financial statements, and the values of our securities.

### Payments of Dividends

The Company is a legal entity separate and distinct from its bank. The prior approval of the OCC is required if the total of all dividends declared by a national bank (such as the Bank) in any calendar year will exceed the sum of such bank's net profits for the year and its retained net profits for the preceding two calendar years, less any required transfers to surplus. Federal law also prohibits any national bank from paying dividends that would be greater than such bank's undivided profits after deducting statutory bad debts in excess of such bank's allowance for possible loan losses.

In addition, the Company and the Bank are subject to various general regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimums. The appropriate federal regulatory authority is authorized to determine under certain circumstances relating to the financial condition of a national or state member bank or a bank holding company that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The OCC and the Federal Reserve have indicated that paying dividends that deplete a national or state member bank's capital base to an inadequate level would be an unsound and unsafe banking practice. The OCC and the Federal Reserve have each indicated that depository institutions and their holding companies should generally pay dividends only out of current operating earnings.

### Capital

The Federal Reserve and the OCC have risk-based capital guidelines for bank holding companies and national banks, respectively. These guidelines require a minimum ratio of capital to risk-weighted assets (including certain off-balance-sheet activities, such as standby letters of credit) of 8%. At least half of the total capital must consist of common equity, retained earnings and a limited amount of qualifying preferred stock, less goodwill and certain core deposit intangibles ("Tier 1 capital"). Voting common equity must be the predominant form of capital. The remainder may consist of non-qualifying preferred stock, qualifying subordinated, perpetual, and/or mandatory convertible debt, term subordinated debt and intermediate term preferred stock

and up to 45% of pretax unrealized holding gains on available for sale equity securities with readily determinable market values that are prudently valued, and a limited amount of any loan loss allowance ("Tier 2 capital" and, together with Tier 1 capital, "Total Capital").

In addition, the Federal Reserve and the OCC have established minimum leverage ratio guidelines for bank holding companies and national banks, which provide for a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets ("leverage ratio") equal to 3%, plus an additional cushion of 1.0% to 2.0%, if the institution has less than the highest regulatory rating. The guidelines also provide that institutions experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Higher capital may be required in individual cases depending upon a bank holding company's risk profile. All bank holding companies and banks are expected to hold capital commensurate with the level and nature of their risks, including the volume and severity of their problem loans. Lastly, the Federal Reserve's guidelines indicate that the Federal Reserve will continue to consider a "tangible Tier 1 leverage ratio" (deducting all intangibles) in evaluating proposals for expansion or new activity. The Federal Reserve and OCC have not advised the Company or the Bank of any specific minimum leverage ratio or tangible Tier 1 leverage ratio applicable to them.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), among other things, requires the federal banking agencies to take "prompt corrective action" regarding depository institutions that do not meet minimum capital requirements. FDICIA establishes five capital tiers: "well capitalized", "adequately capitalized", "undercapitalized", "significantly undercapitalized", and "critically undercapitalized". A depository institution's capital tier will depend upon how its capital levels compare to various relevant capital measures and certain other factors, as established by regulation.

All of the federal banking agencies have adopted regulations establishing relevant capital measures and relevant capital levels. The relevant capital measures are the Total Capital ratio, Tier 1 capital ratio, and the leverage ratio. Under the regulations, a national bank will be (i) well capitalized if it has a Total Capital ratio of 10% or greater, a Tier 1 capital ratio of 6% or greater, and a leverage ratio of at least 5%, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure, (ii) adequately capitalized if it has a Total Capital ratio of 8% or greater, a Tier 1 capital ratio of 4% or greater, and a leverage ratio of 4% or greater (3% in certain circumstances), (iii) undercapitalized if it has a Total Capital ratio of less than 8%, a Tier 1 capital ratio of less than 4% (3% in certain circumstances), (iv) significantly undercapitalized if it has a total capital ratio of less than 6% or a Tier I capital ratio of less than 3%, or a leverage ratio of less than 3%, or (v) critically undercapitalized if its tangible equity is equal to or less than 2% of average quarterly tangible assets.

On March 1, 2005, the Federal Reserve adopted changes to its capital rules that permit qualified trust preferred securities and other restricted capital elements to be included as Tier 1 capital up to 25% of core capital, net of goodwill and intangibles. The Company expects that it will continue to treat its \$13 million of trust preferred securities as Tier 1 capital subject to the limits listed above.

As of December 31, 2007, the consolidated capital ratios of the Bank were as follows:

	<b><u>Regulatory Minimum to be Adequately Capitalized</u></b>	<b><u>Bank</u></b>
Tier 1 capital ratio	4.0%	13.10%
Total capital ratio	8.0%	13.97%
Leverage ratio	3.0-5.0%	11.24%

### **FDICIA**

FDICIA directs that each federal banking regulatory agency prescribe standards for depository institutions and depository institution holding companies relating to internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth compensation, a maximum ratio of classified assets to capital, minimum earnings sufficient to absorb losses, a minimum ratio of market value to book value for publicly traded shares, and such other standards as the federal regulatory agencies deem appropriate.

FDICIA generally prohibits a depository institution from making any capital distribution (including payment of a dividend) or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit a capital restoration plan for approval. For a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee that the institution will comply with such capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of 5% of the depository institution's total assets at the time it became undercapitalized and the amount necessary to bring the institution into compliance with applicable capital standards.

FDICIA also contains a variety of other provisions that may affect the operations of the Company and the Bank, including reporting requirements, regulatory standards for real estate lending, "truth in savings" provisions, the requirement that a depository institution give 90 days' prior notice to customers and regulatory authorities before closing any branch, and a prohibition on the acceptance or renewal of brokered deposits by depository institutions that are not well capitalized or are adequately capitalized and have not received a waiver from the FDIC. The Bank is well capitalized, and brokered deposits are not restricted.

### **Enforcement Policies and Actions**

The Federal Reserve and the OCC monitor compliance with laws and regulations. Violations of laws and regulations, or other unsafe and unsound practices, may result in these agencies imposing fines or penalties, cease and desist orders, or taking other enforcement actions. Under certain circumstances, these agencies may enforce these remedies directly against officers, directors, employees and others participating in the affairs of a bank or bank holding company.

## Fiscal and Monetary Policy

Banking is a business that depends on interest rate differentials. In general, the difference between the interest paid by a bank on its deposits and its other borrowings, and the interest received by a bank on its loans and securities holdings, constitutes the major portion of a bank's earnings. Thus, the earnings and growth of Mountain National and the Bank are subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve. The Federal Reserve regulates the supply of money through various means, including open market dealings in United States government securities, the discount rate at which banks may borrow from the Federal Reserve, and the reserve requirements on deposits. The nature and timing of any changes in such policies and their effect on Mountain National and its subsidiary cannot be predicted. Beginning in September 2007, the Federal Reserve reduced the targeted federal funds rate three times during 2007 for a total of 1.00%. Beginning in August 2007, the Federal Reserve also reduced the discount rate four times during 2007 for a total of 1.50%.

## FDIC Insurance Assessments

The FDIC has adopted a risk-based assessment system for insured depository institutions that takes into account the risks attributable to different categories and concentrations of assets and liabilities. In early 2006, Congress passed the Federal Deposit Insurance Reform Act of 2005, which made certain changes to the Federal deposit insurance program. These changes included merging the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund, increasing retirement account coverage to \$250,000 and providing for inflationary adjustments to general coverage beginning in 2010, providing the FDIC with authority to set the fund's reserve ratio within a specified range, and requiring dividends to banks if the reserve ratio exceeds certain levels. The new statute grants banks an assessment credit based on their share of the assessment base on December 31, 1996, and the amount of the credit can be used to reduce assessments in any year subject to certain limitations. Because it was not organized until 1998, the Bank will not be eligible to receive this one-time assessment credit.

The Bank is subject to FDIC deposit insurance assessments. The FDIC assesses deposits under a risk-based premium schedule. Each financial institution is assigned to one of three capital groups, "well capitalized," "adequately capitalized" or "undercapitalized," and further assigned to one of three subgroups within a capital group, on the basis of supervisory evaluations by the institution's primary federal and, if applicable, state regulators and other information relevant to the institution's financial condition and the risk posed to the applicable insurance fund. The actual assessment rate applicable to a particular institution, therefore, depends in part upon the risk assessment classification so assigned to the institution by the FDIC.

The Deposit Insurance Funds Act of 1996 (the "Funds Act") authorized the Financing Corporation ("FICO") to levy assessments on DIF-assessable deposits. The FICO assessments are set quarterly and ranged from 1.44 basis points for the BIF in the first quarter of 2005 to 1.34 basis points in the last quarter of 2005, from 1.32 basis points in the first quarter of 2006 to 1.24 basis points in the last quarter of 2006, and from 1.22 basis points in the first quarter of 2007 to 1.14 basis points in the last quarter of 2007. The FICO assessment rate for the first quarter of 2008 is 1.12 basis points.

During the three years ended December 31, 2007, the Bank paid \$44,815.83, \$38,291.06 and \$33,911.33 in FICO assessments during 2007, 2006 and 2005, respectively. The Bank paid \$154,734.23 during 2007 for FDIC deposit insurance premiums.

### Other Laws and Regulations

The International Money Laundering Abatement and Anti-Terrorism Funding Act of 2001 specifies “know your customer” requirements that obligate financial institutions to take actions to verify the identity of the account holders in connection with opening an account at any U.S. financial institution. Banking regulators will consider compliance with this Act’s money laundering provisions in acting upon acquisition and merger proposals, and sanctions for violations of this Act can be imposed in an amount equal to twice the sum involved in the violating transaction, up to \$1 million.

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA PATRIOT Act”). Under the USA PATRIOT Act, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as to enhanced due diligence and “know your customer” standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps –

- to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transaction;
- to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;
- to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and
- to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

The USA PATRIOT Act requires financial institutions to establish anti-money laundering programs, and sets forth minimum standards for these programs, including:

- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;
- an ongoing employee training program; and
- an independent audit function to test the programs.

In addition, the USA PATRIOT Act authorizes the Secretary of the Treasury to adopt rules increasing the cooperation and information sharing between financial institutions, regulators, and law enforcement authorities regarding individuals, entities and organizations engaged in, or reasonably suspected based on credible evidence of engaging in, terrorist acts or money laundering activities.

### Legislative and Regulatory Changes

Legislative and regulatory proposals regarding changes in banking, and the regulation of banks, thrifts and other financial institutions and bank and bank holding company powers are being considered by the executive branch of the Federal government, Congress and various state governments, including Tennessee. Other proposals pending in Congress would, among other things, allow banks to pay interest on checking accounts, allow the Federal Reserve to pay interest on deposits, and would permit interstate branching on a *de novo* basis. Certain of these proposals, if adopted, could significantly change the regulation or operations of banks and the financial services industry. It cannot be predicted whether any of these proposals will be adopted, and, if adopted, how these proposals will affect the Company and the Bank.

### **Statistical Information**

Certain statistical and financial information (as required by Guide 3) is included in response to Item 6 and 7 of this Annual Report on Form 10-K.

### **ITEM 1A. RISK FACTORS**

**We have a concentration of credit exposure to borrowers dependent on the tourism industry.**

Due to the predominance of the tourism industry in Sevier County, Tennessee, which is adjacent to the Great Smoky Mountains National Park and the home of the Dollywood theme park, a significant portion of the Bank's commercial loan portfolio is concentrated within that industry. The predominance of the tourism industry also makes our business more seasonal in nature than may be the case with banks in other market areas. The Bank maintains ten primary concentrations of credit by industry, of which five are directly related to the tourism industry. At December 31, 2007, approximately \$179 million in loans, representing approximately 45% of our total loans, were to businesses and individuals whose ability to repay depends to a significant extent on the tourism industry in the markets we serve. We also have additional loans that would be considered related to the tourism industry in addition to the five categories included in the industry concentration amounts noted above. Growth of the tourism industry in Sevier County has remained strong during recent years and we anticipate that this trend will continue; however, if the tourism industry experiences an economic slowdown and, as a result, the borrowers in this industry are unable to perform their obligations under their existing loan agreements, our earnings could be negatively impacted, causing the value of our common stock to decline.

**We are geographically concentrated in Sevier County and Blount County, Tennessee, and changes in local economic conditions impact our profitability.**

We operate primarily in Sevier County and Blount County, Tennessee, and substantially all of our loan customers and most of our deposit and other customers live or have operations in Sevier and Blount Counties. Accordingly, our success significantly depends upon the growth in population, income levels, deposits and housing starts in both counties, along with the continued attraction of business ventures to the area. Our profitability is impacted by the changes in general economic conditions in this market. Additionally, unfavorable local or national economic conditions could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations.

We are less able than a larger institution to spread the risks of unfavorable local economic conditions across a large number of diversified economies. Moreover, we cannot give any assurance that we will benefit from any market growth or favorable economic conditions in our primary market areas if they do occur.

**Our continued growth may require the need for additional capital and further regulatory approvals which, if not obtained, could adversely impact our profitability and implementation of our current business plan.**

To continue to grow, we will need to provide sufficient capital to the Bank through earnings generation, additional equity offerings, the issuance of additional trust preferred securities or borrowed funds or any combination of these sources of funds. Should we incur indebtedness, we could be required to obtain certain regulatory approvals beforehand if we are not well-capitalized under regulatory standards. Should our growth exceed our expectations, we may need to raise additional capital over our projected capital needs. However, our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital if needed on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand and grow our operations could be materially impaired. Should we not be able to obtain such approvals or otherwise not be able to grow our asset base, our ability to attain our long-term profitability goals will be more difficult.

**If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings will decrease.**

If loan customers with significant loan balances fail to repay their loans according to the terms of these loans, our earnings would suffer. We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of any collateral securing the repayment of our loans. We maintain an allowance for loan losses in an attempt to cover the inherent risks associated with lending. In determining the size of this allowance, we rely on an analysis of our loan portfolio based on volume and types of loans, internal loan classifications, trends in classifications, volume and trends in delinquencies, nonaccruals and charge-offs, national and local economic conditions, other factors and other pertinent information. If our assumptions are inaccurate, our current allowance may not be

sufficient to cover potential loan losses, and additional provisions may be necessary which would decrease our earnings.

In addition, federal and state regulators periodically review our loan portfolio and may require us to increase our provision for loan losses or recognize loan charge-offs. Their conclusions about the quality of our loan portfolio may be different than ours. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory agencies could have a negative effect on our operating results.

**Competition with other banking institutions could adversely affect our profitability.**

We face significant competition in our primary market areas from a number of sources, currently including eight commercial banks and one savings institution in Sevier County and eleven commercial banks and one savings institution in Blount County. As of June 30, 2007, there were 50 commercial bank branches and three savings institutions branches located in Sevier County and 44 commercial bank branches and one savings institution branch located in Blount County.

Most of our competitors have been in existence for a longer period of time, are better established, have substantially greater financial resources and have more extensive facilities than we do. Because of the size and established presence of our competitors in our market area, these competitors have longer-term customer relationships than we maintain and are able to offer a wider range of services than we offer.

**Fluctuations in interest rates could reduce our profitability.**

Changes in interest rates may affect our level of interest income, the primary component of our gross revenue, as well as the level of our interest expense, our largest recurring expenditure. Interest rate fluctuations are caused by many factors which, for the most part, are not under our direct control. For example, national monetary policy plays a significant role in the determination of interest rates. Additionally, competitor pricing and the resulting negotiations that occur with our customers also impact the rates we collect on loans and the rates we pay on deposits.

As interest rates change, we expect that we will periodically experience “gaps” in the interest rate sensitivities of our assets and liabilities, meaning that either our interest-bearing liabilities will be more sensitive to changes in market interest rates than our interest-earning assets, or vice versa. In either event, if market interest rates should move contrary to our position, this “gap” may work against us, and our earnings may be negatively affected.

Changes in the level of interest rates also may negatively affect our ability to originate real estate loans, the value of our assets and our ability to realize gains from the sale of our assets, all of which ultimately affect our earnings. A decline in the market value of our assets may limit our ability to borrow additional funds or result in our lenders requiring additional collateral from us under our loan agreements. As a result, we could be required to sell some of our loans and investments under adverse market conditions, upon terms that are not favorable to us, in order to maintain our liquidity. If those sales are made at prices lower than the amortized costs of the investments, we will incur losses.

**Our common stock is currently traded on the over-the-counter, or OTC, bulletin board and has substantially less liquidity than the average stock quoted on a national securities exchange.**

Although our common stock is publicly traded on the OTC bulletin board, our common stock has substantially less daily trading volume than the average trading market for companies quoted on the Nasdaq National Market, or any national securities exchange. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control.

The market price of our common stock may fluctuate in the future, and these fluctuations may be unrelated to our performance. General market price declines or overall market volatility in the future could adversely affect the price of our common stock, and the current market price may not be indicative of future market prices.

**Loss of our senior executive officers or other key employees could impair our relationship with our customers and adversely affect our business.**

We have assembled a senior management team which has substantial background and experience in banking and financial services and in the Sevier County and Blount County, Tennessee banking markets. Loss of the services of any of these key personnel could negatively impact our business because of their skills, years of industry experience, customer relationships and the potential difficulty of promptly replacing them.

**Our business is dependent on technology, and an inability to invest in technological improvements may adversely affect our results of operations and financial condition.**

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. We have made significant investments in data processing, management information systems and internet banking accessibility. Our future success will depend in part upon our ability to create additional efficiencies in our operations through the use of technology, particularly in light of our past and projected growth strategy. Many of our competitors have substantially greater resources to invest in technological improvements. There can be no assurance that our technological improvements will increase our operational efficiency or that we will be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

**We are subject to various statutes and regulations that may limit our ability to take certain actions.**

We operate in a highly regulated industry and are subject to examination, supervision, and comprehensive regulation by various regulatory agencies. Our compliance with these regulations is costly and restricts certain of our activities, including payment of dividends,

mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices. We are also subject to capitalization guidelines established by our regulators, which require us to maintain adequate capital to support our growth.

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the effects of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, our cost of compliance could adversely affect our ability to operate profitably.

**If a change in control or change in management is delayed or prevented, the market price of our common stock could be negatively affected.**

Certain federal and state regulations may make it difficult, and expensive, to pursue a tender offer, change in control or takeover attempt that our board of directors opposes. As a result, our shareholders may not have an opportunity to participate in such a transaction, and the trading price of our stock may not rise to the level of other institutions that are more vulnerable to hostile takeovers.

## **ITEM 2. PROPERTIES**

The Bank currently operates from its main office in Sevierville, Tennessee and seven branch offices located in Gatlinburg, Pigeon Forge, Seymour, Kodak and Maryville, Tennessee. The main office, which is located at 300 East Main, Sevierville, Tennessee 37862, contains approximately 24,000 square feet and is owned by the Bank.

The first Gatlinburg branch was built in 1999 and is located at 960 E. Parkway. It contains approximately 4,800 square feet. The Bank leases the land at this location. The lease expires in 2013 and includes renewal options for twelve additional five-year terms.

The second Gatlinburg branch is a walk-up branch leased by the Bank located at 745 Parkway, which lies in the heart of the Gatlinburg tourist district. The lease expires in 2010 and includes two five-year renewal options through 2020.

The Pigeon Forge branch, owned by the Bank, contains approximately 3,800 square feet and is located at 3104 Teaster Lane, Pigeon Forge, Tennessee.

The second Pigeon Forge branch, owned by the Bank, contains approximately 3,800 square feet and is located at 242 Wears Valley Road, Pigeon Forge, Tennessee.

The Seymour branch, owned by the Bank, contains approximately 3,800 square feet and is located on Chapman Highway, Seymour, Tennessee.

The Kodak branch, owned by the Bank, contains approximately 3,800 square feet and is located on Winfield Dunn Parkway – Highway 66, Sevierville, Tennessee.

The Collier Drive branch, owned by the Bank, contains approximately 3,800 square feet and is located at 470 Collier Drive, Sevierville, Tennessee. This branch was under construction at December 31, 2007 and opened for business during the first quarter of 2008.

The West Maryville branch, owned by the Bank, contains approximately 4,800 square feet and is located at 2403 US Highway 411 South, Maryville, Tennessee.

The Operations Center, owned by the Bank, contains approximately 24,000 square feet and is located on Red Bank Road in Sevierville, Tennessee. We began construction of an additional 16,000 square feet during the fourth quarter of 2007 and we anticipate a completion date during the third quarter of 2008.

In addition to our ten existing locations, we purchased two additional properties in Blount County, and one in Sevier County, Tennessee, for future branches. We have begun construction on both sites in Blount County with anticipated opening dates for a branch during the second quarter of 2008 and the Blount County Regional Office during the first quarter of 2009. We will have eleven branches when they are completed, including the Main and Regional offices. During the first quarter of 2007, we purchased one property in Sevier County and one property in Knox County, Tennessee, which we also intend to use for future branch sites. Plans for construction of the branch in Sevier County are currently being developed and we anticipate beginning construction during the third or fourth quarter of 2008.

Management believes that the physical facilities maintained by the Bank are suitable for its current operations and that all properties are adequately covered by insurance.

### **ITEM 3. LEGAL PROCEEDINGS**

The Company is not aware of any material pending legal proceedings to which the Company or the Bank is a party or to which any of their properties are subject, other than ordinary routine legal proceedings incidental to the business of the Bank.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of the Company's shareholders, through the solicitation of proxies or otherwise, during the fourth quarter of 2007.

## **PART II**

### **ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

There is not a large market for the Company's shares, which are quoted on the OTC Bulletin Board under the symbol "MNBT" and are not traded on any national exchange. Trading is generally limited to private transactions and, therefore, there is limited reliable information available as to the number of trades or the prices at which our stock has traded. Management has reviewed the limited information available regarding the range of prices at which the Company's common stock has been sold. The following table sets forth, for the calendar periods indicated,

the range of high and low reported sales prices and the closing price for each period. This data is provided for information purposes only and should not be viewed as indicative of the actual or market value of our common stock:

<u>Year/Period</u>	<u>Market Price Range</u>	
	<u>Per Share</u>	
	<u>High</u>	<u>Low</u>
2007:	\$ 28.57	\$ 22.00
First Quarter	26.67	25.71
Second Quarter	27.67	25.71
Third Quarter	28.57	27.43
Fourth Quarter	27.43	22.00
2006:	\$ 27.21	\$ 23.54
First Quarter	24.62	23.54
Second Quarter	27.21	24.62
Third Quarter	26.85	25.04
Fourth Quarter	26.08	24.94

On March 14, 2008, the last reported sale price for the common stock was \$22.25 per share.

These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual transactions. They have been adjusted to reflect the five percent stock dividends issued June 2006, February 2007 and March 2008.

As of the date of this filing, the Company has approximately 2,000 holders of record of its common stock. The Company has no other class of securities issued or outstanding.

Dividends from the Bank are the Company's primary source of funds to pay dividends on its capital stock. Under the National Bank Act, the Bank may, in any calendar year, without the approval of the OCC, pay dividends to the extent of net profits for that year, plus retained net profits for the preceding two years (less any required transfers to surplus). The need to maintain adequate capital in the Bank also limits dividends that may be paid to the Company. The OCC and Federal Reserve have the general authority to limit the dividends paid by insured banks and bank holding companies, respectively, if such payment may be deemed to constitute an unsafe or unsound practice. If, in the particular circumstances, the OCC determines that the payment of dividends would constitute an unsafe or unsound banking practice, the OCC may, among other things, issue a cease and desist order prohibiting the payment of dividends. This rule is not expected to adversely affect the Bank's ability to pay dividends to the Company. Additional information regarding restrictions on the ability of the Bank to pay dividends to the Company is contained in this report under "Item 1 - Business- Supervision and Regulation."

On June 23, 2006, we issued a five percent stock dividend to stockholders of record as of June 1, 2006. In lieu of fractional shares, we made a total cash payment of \$23,002, based on a price of \$27.85 per share, adjusted to reflect the five percent stock dividends issued during June

2006, February 2007 and March 2008. The total number of shares issued pursuant to the dividend was 90,878.

On February 28, 2007, we issued a five percent stock dividend to stockholders of record as of February 15, 2007. In lieu of fractional shares, we made a total cash payment of \$29,557, based on a price of \$26.19 per share, adjusted to reflect the five percent stock dividend issued during March 2008. The total number of shares issued pursuant to the dividend was 96,361.

On March 7, 2008, we issued a five percent stock dividend to stockholders of record as of February 15, 2008. In lieu of fractional shares, we made a cash payment totaling \$17,802, based on a price of \$24.00 per share. The total number of shares issued pursuant to the dividend was 124,718.

No cash dividends have been declared or paid by the Company.

#### Issuer Purchases of Equity Securities

On July 6, 2007, the Company announced the authorization by the Board of Directors of a repurchase plan of up to \$500,000 of the Company's common stock prior to June 27, 2008. The stock repurchases have been accomplished in private or open-market purchases and the timing of the repurchases and the number of shares of common stock to be purchased is dependent upon prevailing market conditions, share price, and other factors.

The following table provides certain information for the fourth quarter ended December 31, 2007 with respect to the Company's repurchase of common stock.

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
October 1-31, 2007	-	\$ -	-	\$ 227,000
November 1-30, 2007	1,000	27.00	1,000	200,000
December 1-31, 2007	-	-	-	200,000
<b>Total</b>	<b>1,000</b>	<b>\$ 27.00</b>	<b>1,000</b>	<b>200,000</b>

#### **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

To better understand financial trends and performance, our management analyzes certain key financial data in the following pages. This analysis and discussion reviews our results of operations for the three-year period ended December 31, 2007, and our financial condition at December 31, 2006 and 2007. We have provided comparisons of financial data as of and for the fiscal years ended December 31, 2005, 2006 and 2007, to illustrate significant changes in performance and the possible results of trends revealed by that historical financial data. The following discussion should be read in conjunction with our consolidated audited financial

statements, including the notes thereto, and the selected consolidated financial data presented elsewhere in this Annual Report on Form 10-K.

## **Overview**

We conduct our business, which consists primarily of traditional commercial banking operations, through our wholly owned subsidiary, Mountain National Bank. Through the Bank we offer a broad range of traditional banking services from our corporate headquarters in Sevierville, Tennessee, and through eight additional branches in Sevier County and Blount County, Tennessee. Our banking operations primarily target individuals and small businesses in Sevier and Blount Counties and the surrounding area. The retail nature of the Bank's commercial banking operations allows for diversification of depositors and borrowers, and we do not believe that the Bank is dependent upon a single or a few customers. Due to the predominance of the tourism industry in Sevier County, a significant portion of the Bank's commercial loan portfolio is concentrated within that industry. The predominance of the tourism industry also makes our business more seasonal in nature, particularly with respect to deposit levels, than may be the case with banks in other market areas. Growth of the tourism industry in Sevier County has remained strong during recent years and we anticipate that this trend will continue.

## **Critical Accounting Policies**

Our accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices accepted within the banking industry. Our significant accounting policies are described in the notes to our consolidated financial statements. Certain accounting policies require management to make significant estimates and assumptions that have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions used are based on historical experience and other factors that management believes to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions, which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and on our results of operations for the reporting periods.

We believe the following are the critical accounting policies that require the most significant estimates and assumptions and that are particularly susceptible to a significant change in the preparation of our financial statements.

### **Impairment of Investment Securities**

Management conducts regular reviews to assess whether the values of our investments are impaired and whether any such impairment is other than temporary. If management determines that the value of any investment is other-than-temporarily impaired, we record a charge against earnings equal to the amount of the impairment. The determination of whether other-than-temporary impairment has occurred involves significant assumptions, estimates and judgments by management. Changing economic conditions – global, regional or related to industries of specific issuers – could adversely affect these values. We recorded no other than temporary impairment of our investment securities during 2005, 2006 or 2007.

## **Allowance and Provision for Loan Losses**

The allowance and provision for loan losses is based on management's assessments of amounts that it deems to be adequate to absorb losses inherent in our existing loan portfolio. The allowance for loan losses is established through a provision for losses based on management's evaluation of current economic conditions, volume and composition of the loan portfolio, the fair market value or the estimated net realizable value of underlying collateral, historical charge off experience, the level of nonperforming and past due loans, and other indicators derived from reviewing the loan portfolio. The evaluation includes a review of all loans on which full collection may not be reasonably assumed. Should the factors that are considered in determining the allowance for loan losses change over time, or should management's estimates prove incorrect, a different amount may be reported for the allowance and the associated provision for loan losses. For example, if economic conditions in our market area undergo an unexpected and adverse change, we may need to increase our allowance for loan losses by taking a charge against earnings in the form of an additional provision for loan losses.

## **Results of Operations for the Years Ended December 31, 2007, 2006 and 2005**

### **General Discussion of Our Results**

Our principal source of revenue is net interest income at the Bank. Net interest income is the difference between:

- income received on interest-earning assets, such as loans and investment securities; and
- payments we make on our interest-bearing sources of funds, such as deposits and borrowings.

The level of net interest income is determined primarily by the average balances, or volume, of interest-earning assets and interest-bearing liabilities and the various rate spreads between the interest-earning assets and the Company's funding sources. Changes in our net interest income from period to period result from, among other things:

- increases or decreases in the volumes of interest-earning assets and interest-bearing liabilities;
- increases or decreases in the average rates earned and paid on those assets and liabilities;
- our ability to manage our interest-earning asset portfolio, which includes loans;
- the availability and costs of particular sources of funds, such as non-interest bearing deposits; and
- our ability to "match" liabilities to fund assets of similar maturities at a profitable spread of rates earned on assets over rates paid on liabilities.

In 2007, 2006 and 2005, our other principal sources of revenue were service charges on deposit accounts, credit/debit card related income and gains on the sale of mortgage loans.

## Net Income

Our results for the periods ended December 31, 2007, 2006 and 2005 were marked by the continued growth in loans and other earning assets as well as in deposits and FHLB borrowings, which resulted in increased revenues and expenses. The following is a summary of our results of operations (dollars in thousands except per share amounts):

	Years Ended December 31,			Dollar Change		Percent Change	
	2007	2006	2005	2007 to 2006	2006 to 2005	2007 to 2006	2006 to 2005
Interest income	\$ 36,714	\$ 29,001	\$ 19,224	\$ 7,713	\$ 9,777	26.60%	50.86%
Interest expense	19,028	13,117	6,749	5,911	6,368	45.06%	94.35%
Net interest income	17,686	15,884	12,475	1,802	3,409	11.34%	27.33%
Provision for loan losses	982	915	446	67	469	7.32%	105.16%
Net interest income after provision for loan losses	16,704	14,969	12,029	1,735	2,940	11.59%	24.44%
Noninterest income	3,742	3,246	2,676	496	570	15.28%	21.30%
Noninterest expense	15,240	13,023	10,127	2,217	2,896	17.02%	28.60%
Net income before income taxes	5,206	5,192	4,578	14	614	0.27%	13.41%
Income tax expense	1,294	1,295	1,454	(1)	(159)	-0.08%	-10.94%
Net income	<u>\$ 3,912</u>	<u>\$ 3,897</u>	<u>\$ 3,124</u>	<u>\$ 15</u>	<u>\$ 773</u>	<u>0.38%</u>	<u>24.74%</u>
Total revenues	\$ 40,456	\$ 32,247	\$ 21,900	\$ 8,209	\$ 10,347	25.46%	47.25%
Total expenses	36,544	28,350	18,776	8,194	9,574	28.90%	50.99%
Basic earnings per share	1.68	1.93	1.81				
Diluted earnings per share	1.61	1.79	1.69				

The slight increase in net income in 2007 as compared with 2006 was primarily attributable to the increase in net interest income. This increase was primarily due to the increase in total average loans of approximately \$80,287,000 from December 31, 2006 to December 31, 2007. There was no change in the Fed Funds Rate by the Federal Reserve's Federal Open Market Committee ("FOMC") from June 2006 through August 2007, which created a stable interest rate environment. However, local competition caused our cost of funds to remain higher in light of the 100 basis point drop in the fed funds rate in the last four months of 2007 than would otherwise have been expected. The increase in income was somewhat offset by the 100 basis point decrease in the target federal funds rate during the last four months of 2007. This is due to our interest-earning assets repricing more frequently and more closely tracking changes in market interest rates than did our interest-bearing liabilities. The increase in noninterest expense also offset the increase in interest income and is due to the continued investment by the Bank in future branch locations and the expansion of our operations center coupled with the associated personnel costs of staffing for the future growth. Total expenses increased during 2007 as compared to 2006 primarily due to an increase in interest expense caused by the increase in interest bearing liabilities, and an increase in non-interest expense primarily related to increases in employee salaries and benefits and marketing relating to our continued expansion of our workforce and markets, and legal and professional costs relating to compliance with the Sarbanes Oxley Act.

During 2007, management anticipated the downward pressure on interest rates would continue into 2008. As a result, the Bank increased the fixed rate loan portfolio in an attempt to

somewhat mitigate the effect of the expected decrease in the rate environment. At December 31, 2007, there was approximately \$140 million in loans tied to prime that reprice immediately with a change in the prime rate versus approximately \$130 million in loans at December 31, 2006. However, the majority of the more than \$80 million increase in total loans during 2007 was fixed rate loans with maturities of approximately three years or less, and loans that reprice less frequently than the daily adjustable rate loans mentioned above. This shift in fixed rate loans will positively impact our results of operations if rates stay at or below current levels and borrowers do not repay these loans in advance of maturity. If, however, rates were to rise above current levels or the levels in place when these loans were made, our results of operations may be negatively impacted.

The increase in net income in 2006 from 2005 was primarily attributable to a significant increase in net interest income from loans and securities available for sale. The increased net interest income attributable to loans and to securities available for sale resulted from the increase in our loan and securities portfolios and a rising interest rate environment during the first half of 2006. Increased earnings on interest-earning assets exceeded the increased expense from the growth in interest-bearing liabilities, resulting in an improvement in net interest income.

The increase in our total expenses for 2006 as compared to 2005 was primarily due to an increase in interest expense due to growth in interest bearing liabilities and the rising rate environment during 2006 and an increase in employee salaries and benefits that primarily resulted from expansion of our workforce. The one hundred basis point total increase in the Fed Funds Rate by the FOMC during 2006, which resulted in concomitant increases in the prime-lending rate, contributed to our improved net income during the year. The Bank had approximately \$130 million in loans tied to the prime lending rate that re-price with each rate increase. The rising market interest rates during the first half of 2006 positively affected our net interest income because our interest-earning assets re-priced more frequently and more closely tracked changes in market interest rates than did our interest-bearing liabilities. During the second half of 2006, rates paid on interest-earning assets stabilized while rates paid on interest-bearing liabilities continued to increase due to local market competition.

Basic and diluted earnings per share were \$1.68 and \$1.61, respectively, for 2007, compared to \$1.93 and \$1.79, respectively, for 2006, compared to \$1.81 and \$1.69, respectively, for 2005 reflecting the issuance of 459,742 shares (adjusted for 5% stock dividend) in 2007 in connection with the exercise of warrants we had previously issued and that expired on September 7, 2007 and a 5% stock dividend paid on March 7, 2007. Additionally, the changes in basic and diluted earning per share reflect 90,878 shares issued in 2006 as a result of a 5% stock dividend paid on February 28, 2006. See "Note 14 Stock Options and Warrants" for a more detailed discussion of shares issued.

The Bank's net interest margin, the difference between the yields on earning assets, including loan fees, and the rate paid on funds to support those assets, reduced slightly during the first quarter of 2007 then remained relatively steady during the rest of the year. Management's lending strategy mentioned above that resulted in an increase in fixed rate loans contributed to this stability. Management does not believe this trend of a stable net interest margin will continue during 2008 due to the current market pressures on interest rates. See the section titled "Interest Expense and Net Interest Margin," below for a more detailed discussion.

The Bank's net interest margin was fairly stable during the first half of 2006, then reduced during the second half of the year. This compression of the net interest margin was due primarily to the continued pressure to increase the rates paid on our interest-bearing liabilities while the rates we earn on our interest earning assets became more stable. This is in contrast to 2005 when we had an increasing net interest margin due to an increasing interest rate environment and our net interest margin increased during the year because our interest-earning assets re-priced more frequently and more closely tracked changes in market interest rates than did our interest-bearing liabilities.

The following chart illustrates our net income for the periods indicated. The changes below were impacted by changes in rate as well as changes in volume:

	<u>2007</u>		<u>2006</u>		<u>2005</u>
First Quarter	\$ 901,478	\$	935,453	\$	640,171
Second Quarter	1,026,037		1,046,081		720,863
Third Quarter	1,006,677		951,271		862,185
Fourth Quarter	<u>977,902</u>		<u>964,568</u>		<u>900,283</u>
Annual Total	\$ 3,912,094	\$	3,897,373	\$	3,123,502

The following discussion and analysis describes, in greater detail, the specific changes in each income statement component.

## **Net Interest Income**

### Average Balances, Interest Income, and Interest Expense

The following table contains condensed average balance sheets for the years indicated. In addition, the amount of our interest income and interest expense for each category of interest-earning assets and interest-bearing liabilities and the related average interest rates, net interest spread and net yield on average interest earning assets are included.

**Average Balance Sheet and Analysis of Net Interest Income  
for the Years Ended December 31,  
(Dollars in thousands)**

	2007			2006			2005		
	Average Balances	Interest	Rates/ Yields	Average Balances	Interest	Rates/ Yields	Average Balances	Interest	Rates/ Yields
<b>Interest-earning assets:</b>									
Loans (1)(2)	\$ 373,237	\$ 32,267	8.65%	\$ 292,950	\$ 25,287	8.63%	\$ 227,910	\$ 16,545	7.26%
<b>Investment Securities: (3)</b>									
Available for sale	80,168	3,915	4.88%	69,339	3,281	4.73%	54,658	2,378	4.35%
Held to maturity	1,916	92	4.80%	1,444	68	4.71%	1,093	54	4.94%
Equity securities	3,187	186	5.84%	2,053	128	6.23%	1,509	72	4.77%
<b>Total securities</b>	<u>85,271</u>	<u>4,193</u>	<u>4.92%</u>	<u>72,836</u>	<u>3,477</u>	<u>4.77%</u>	<u>57,260</u>	<u>2,504</u>	<u>4.37%</u>
Federal funds sold and other	5,116	254	4.96%	4,721	237	5.02%	4,899	175	3.57%
<b>Total interest-earning assets</b>	<u>463,624</u>	<u>36,714</u>	<u>7.92%</u>	<u>370,507</u>	<u>29,001</u>	<u>7.83%</u>	<u>290,069</u>	<u>19,224</u>	<u>6.63%</u>
<b>Nonearning assets</b>	<u>45,361</u>			<u>37,706</u>			<u>29,806</u>		
<b>Total Assets</b>	<u>\$ 508,985</u>			<u>\$ 408,213</u>			<u>\$ 319,875</u>		
<b>Interest-bearing liabilities:</b>									
<b>Interest bearing deposits:</b>									
<b>Interest bearing</b>									
demand deposits	\$ 127,704	\$ 4,949	3.88%	\$ 120,268	\$ 4,477	3.72%	\$ 98,356	\$ 2,142	2.18%
Savings deposits	8,673	91	1.05%	7,860	48	0.61%	6,764	40	0.59%
Time deposits	196,654	10,032	5.10%	146,014	6,249	4.28%	117,415	3,503	2.98%
<b>Total interest bearing deposits</b>	<u>333,031</u>	<u>15,072</u>	<u>4.53%</u>	<u>274,142</u>	<u>10,774</u>	<u>3.93%</u>	<u>222,535</u>	<u>5,685</u>	<u>2.55%</u>
Securities sold under agreements to repurchase	5,815	158	2.72%	4,779	102	2.13%	4,287	64	1.49%
Federal Home Loan Bank advances and other borrowings	60,970	2,812	4.61%	31,716	1,493	4.71%	18,228	650	3.57%
Subordinated debt	13,403	986	7.36%	10,181	748	7.35%	5,671	350	6.17%
<b>Total interest-bearing liabilities</b>	<u>413,219</u>	<u>19,028</u>	<u>4.60%</u>	<u>320,818</u>	<u>13,117</u>	<u>4.09%</u>	<u>250,721</u>	<u>6,749</u>	<u>2.69%</u>
<b>Noninterest-bearing deposits</b>	<u>53,336</u>			<u>54,163</u>			<u>46,187</u>		
<b>Total deposits and interest-bearing liabilities</b>	<u>466,555</u>	<u>19,028</u>	<u>4.08%</u>	<u>374,981</u>	<u>13,117</u>	<u>3.50%</u>	<u>296,908</u>	<u>6,749</u>	<u>2.27%</u>
Other liabilities	2,565			2,066			1,739		
<b>Shareholders' equity</b>	<u>39,865</u>			<u>31,166</u>			<u>21,228</u>		
	<u>\$ 508,985</u>			<u>\$ 408,213</u>			<u>\$ 319,875</u>		
<b>Net interest income</b>		<u>\$ 17,686</u>			<u>\$ 15,884</u>			<u>\$ 12,475</u>	
Net interest spread (4)			3.32%			3.74%			3.94%
Net interest margin (5)			3.81%			4.29%			4.30%

(1) Interest income from loans includes total fee income of approximately \$2,138,000, \$2,091,000 and \$1,673,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

(2) For the purpose of these computations, non-accrual loans are included in average loans.

(3) Tax-exempt income from investment securities is not presented on a tax-equivalent basis.

(4) Yields realized on interest-earning assets less the rates paid on interest-bearing liabilities.

(5) Net interest margin is the result of net interest income divided by average interest-earning assets for the period.

As mentioned above the increase in net interest income was attributable primarily to an increase in our interest-earning assets. Our investment securities portfolio continued to perform above our peer group average during 2007. As was the case during 2006, the growth of our real estate secured loans in 2007 contributed to the increase in net interest income as the Bank was also able to increase the yield on those loans as compared to the 2006 yield. This increase is attributable to the Bank being more aggressive with its fixed rate lending and overall pricing strategies for loans. The yield on investments continued to increase from 2006 and 2005 levels as well. As can be noted from the increase in the rates paid on deposits, even though 2007 was a

stable to declining rate environment when FOMC activity is considered, the Bank's cost of deposits increased for all categories shown in the chart above. As mentioned previously, the local competition for deposits caused interest rates paid on deposits to remain at above market levels during 2007 and we expect this trend to continue in 2008.

We anticipate that a continued reduction in the target Federal Funds Rate will negatively impact our net interest income during future periods because our interest-earning assets typically re-price more frequently than do our interest-bearing liabilities. There is continued upward pressure on the rates we pay for our deposits due to increased local competition. However, if the target Federal Funds Rate were to increase, net interest income will be positively impacted. The magnitude of the impact from changes in the target Federal Funds Rate, both increases and decreases, has been somewhat reduced due to the increase in fixed rate loan balances. The interest income we earn on loans is the largest contributing component of net interest income and the Bank's net interest margin.

During 2006, the increase in net interest income was attributable primarily to an increase in our interest-earning assets. Additionally, our investment securities portfolio continued to perform above our peer group average. Continued strong growth in our loan portfolio, particularly real estate secured loans, contributed to higher average outstanding balances of those interest-earning assets and at higher yields than we paid on interest-bearing deposits and borrowings. See the additional discussion under "Discussion of Financial Condition – Loans."

Also contributing to our growth in net interest income during 2006 was the approximately \$17,566,000 growth in our portfolio of investment securities, which was funded primarily by the approximately \$19.3 million growth in NOW deposit accounts. The increase in income on investment securities was primarily attributable to increases in our average investment securities during 2006, in addition to a 34 basis point increase in the net yield on these average balances from 4.37% in 2005 to 4.77% in 2006. See additional discussion under "Discussion of Financial Condition – Investment Securities."

### Rate and Volume Analysis

The following table sets forth the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have affected our interest income and interest expense during the years indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) change in volume (change in volume multiplied by previous year rate); (2) change in rate (change in rate multiplied by current year volume); and a combination of change in rate and change in volume. The changes in interest income and interest expense attributable to both volume and rate have been allocated proportionately to the change due to volume and the change due to rate.

**ANALYSIS OF CHANGES IN NET INTEREST INCOME  
FOR THE YEARS ENDED DECEMBER 31,  
(Dollars in thousands)**

	<b>2007 Compared to 2006</b>		
	<b>Increase (decrease) due to change in</b>		
	<u>Rate</u>	<u>Volume</u>	<u>Total</u>
<b>Income from interest-earning assets:</b>			
Interest and fees on loans	\$ 50	\$ 6,930	\$ 6,980
Interest on securities	122	594	716
Interest on Federal funds sold and other	<u>(3)</u>	<u>20</u>	<u>17</u>
Total interest income	169	7,544	7,713
<b>Expense from interest-bearing liabilities:</b>			
Interest on interest-bearing deposits	224	291	515
Interest on time deposits	1,616	2,167	3,783
Interest on other borrowings	<u>(69)</u>	<u>1,682</u>	<u>1,613</u>
Total interest expense	<u>1,771</u>	<u>4,140</u>	<u>5,911</u>
Net interest income	\$ (1,602)	\$ 3,404	\$ 1,802

	<b>2006 Compared to 2005</b>		
	<b>Increase (decrease) due to change in</b>		
	<u>Rate</u>	<u>Volume</u>	<u>Total</u>
<b>Income from interest-earning assets:</b>			
Interest and fees on loans	\$ 4,017	\$ 4,725	\$ 8,742
Interest on securities	251	722	973
Interest on Federal funds sold and other	<u>70</u>	<u>(8)</u>	<u>62</u>
Total interest income	4,338	5,439	9,777
<b>Expense from interest-bearing liabilities:</b>			
Interest on interest-bearing deposits	1,868	476	2,344
Interest on time deposits	1,892	852	2,744
Interest on other borrowings	<u>583</u>	<u>697</u>	<u>1,280</u>
Total interest expense	<u>4,343</u>	<u>2,025</u>	<u>6,368</u>
Net interest income	\$ (5)	\$ 3,414	\$ 3,409

**Provision for Loan Losses**

The provision for loan losses is based on management's evaluation of economic conditions, volume and composition of the loan portfolio, historical charge-off experience, the level of nonperforming and past due loans, and other indicators derived from reviewing the loan

portfolio. Management performs such reviews quarterly and makes appropriate adjustments to the level of the allowance for loan losses as a result of these reviews.

The increase in the provision for loan losses during 2007 and 2006, as compared to 2005, was based on management's evaluation of the overall allowance for loan losses relative to management's assessment of the risk of losses inherent in our loan portfolio. Total loans increased approximately \$53 million and \$95 million during 2007 and 2006, respectively, as compared to an increase of approximately \$40 million during 2005. Management has continued to focus on maintaining our allowance for loan losses at levels that reflect the risk associated with the loan portfolio.

Management believes that its current credit-granting and administration processes follow a comprehensive and disciplined approach that mitigates risk and lowers the likelihood of significant increases in charge-offs and non-performing loans, although all credit-granting processes require subjective judgments and estimates. For additional information refer to the discussion under "Discussion of Financial Condition – Allowance for Loan Losses."

### Noninterest Income

The following table presents the major components of noninterest income for 2007, 2006 and 2005 (dollars in thousands).

	Years Ended December 31,			Dollar Change		Percent Change	
	2007	2006	2005	2007 to 2006	2006 to 2005	2007 to 2006	2006 to 2005
Service charges on deposit accounts	\$ 1,414	\$ 1,293	\$ 1,142	\$ 121	\$ 151	9.36%	13.22%
Other fees and commissions	1,153	1,020	891	133	129	13.04%	14.48%
Gain on sale of mortgage loans	323	424	401	(101)	23	-23.82%	5.74%
Other noninterest income	852	509	187	343	322	67.39%	172.19%
<b>Total noninterest income</b>	<b>3,742</b>	<b>3,246</b>	<b>2,621</b>	<b>496</b>	<b>625</b>	<b>15.28%</b>	<b>23.85%</b>

The principal components of noninterest income during 2005, 2006 and 2007 were service charges on deposits, fees associated with credit/debit cards included in "other fees and commissions", and income resulting from the increase in the cash surrender value of bank owned life insurance ("BOLI"). The increased income from service charges and the approximately \$130,000 and \$145,000 increases in credit/debit card income for 2007 and 2006, respectively, were due to the increase in the Bank's customer base and their continued increased usage of debit and credit cards. The decrease in gain on sale of mortgage loans during 2007 was due to a reduction in staff of the mortgage department and a general downturn in the home sales market in the Sevier and Blount County market areas during the year. The increase in other noninterest income included an increase of approximately \$29,000 and \$184,000 for 2007 and 2006, respectively, from the cash surrender value of BOLI resulting from the Bank's investment of approximately \$3,950,000 in BOLI from November 2005 to February 2006. Other noninterest income increased approximately \$93,000 and \$59,000 for 2007 and 2006, respectively, due to the income generated from the Bank's investment in Appalachian Fund for Growth II, an LLC the Bank invested in during the first quarter of 2006 that invests in low income areas and which generates tax credits for its members like the Company. Also included in other noninterest income during 2007 was a gain on sale of other real estate owned in the amount of \$274,000, including a gain of approximately \$189,000 discussed in more detail under "Discussion of Financial Condition - Allowance for Loan Losses."

## **Interest Expense and Net Interest Margin**

The increase in interest expense during 2007 as compared to 2006 was due to the general increase in interest rates paid on deposits, primarily demand deposit accounts and time deposits, including brokered deposits, and borrowed funds. The increase in the average balances of time deposits of over \$50 million, the increase in Federal Home Loan Bank advances of more than \$25 million and the increase in subordinated debt of over \$3 million also contributed to the increased interest expense. The interest rates paid on all interest bearing liabilities, with the exception of Federal Home Loan Bank advances, increased during 2007 over rates paid during 2006. As mentioned previously, local competition caused an increase in deposit interest rates during 2007, even though there was no change in the Federal Funds rate prior to September 2007, after which the Federal Funds rate decreased 100 basis points in 2007.

The increase in interest expense during 2006 as compared to 2005 resulted primarily from an increase in the interest rates we paid on interest-bearing deposits and short-term borrowings during 2006 relative to 2005. Growth in average balances also contributed to the increase. The increase in interest expense on deposits for 2006 was attributable to both the increase of approximately \$72 million in the balance of our interest-bearing deposits in 2006 relative to 2005 and to the repricing of our existing interest-bearing deposits to higher rates during 2006.

The increase in interest expense related to other borrowings for 2006 was primarily due to an increase in the average balance due in other borrowed funds, which resulted primarily from an increase of over \$14 million in average Federal Home Loan Bank borrowings. The higher cost of borrowed funds due to the increases in the federal funds overnight rate also impacted interest expense. Additionally, the Company had an increase of over \$4 million in the average balance of subordinated debentures. Rising interest rates in 2006 caused the cost of borrowed funds to increase for our subordinated debentures and for the Bank's Federal Home Loan Bank advances and overnight federal funds purchases. The average balance in other borrowed funds increased by approximately \$18 million during 2006, and we used this funding to promote our continued growth.

Our net interest margin, the difference between the yield on earning assets, including loan fees, and the rate paid on funds to support those assets, averaged 3.81% during 2007 versus 4.29% in 2006, a decrease of 48 basis points. The decrease in our net interest margin reflects a decrease in the average spread in 2007 between the rates we earned on our interest-earning assets, which had an increase in overall yield of 9 basis points to 7.92% at December 31, 2007, as compared to 7.83% at December 31, 2006, and the rates we paid on interest-bearing liabilities, which had an increase in the overall rate of 58 basis points to 4.08% at December 31, 2007, versus 3.50% at December 31, 2006. The stability of the Federal Funds rate from June 2006 through August of 2007 allowed our interest-bearing liabilities to fully reprice to the lower market rates after the rising rate environment during the first half of 2006. As noted from the difference in the increase in our yield we earned on our interest-earning assets as compared to the increase in the rates paid on our interest-bearing liabilities, a 9 basis point increase versus a 58 basis point increase, respectively, the repricing of our liabilities due to market competition created the upward pressure on our interest costs. The cost of borrowed funds did remain relatively stable and were readily available at rates below our local deposit market rates.

Our net interest margin averaged 4.29% in 2006 versus 4.30% during 2005, a decrease of one basis point. The decrease in our net interest margin reflects a decrease in the average spread in 2006 between the rates we earned on our interest-earning assets, which had an increase in overall yield of 118 basis points to 7.79% at December 31, 2006, as compared to 6.61% at December 31, 2005 and the rates we paid on interest-bearing liabilities, which had an increase in the overall rate of 140 basis points to 4.09% at December 31, 2006, versus 2.69% at December 31, 2005. The decrease in our net interest margin during 2006, a year in which the Federal Funds rate increased by a total of 100 basis points during the first half of the year then remain unchanged during the last half of the year reflected this trend. Also, the Bank's increased reliance on borrowed funds and brokered deposits has caused the net interest margin to remain somewhat depressed due to the higher cost of these funds during the short-term period until core deposits increase. Due to the Federal Funds Rate remaining unchanged during the last half of 2006, pressure has been exerted on the Bank to increase the rates paid on interest-bearing liabilities as they reprice. We anticipate in this current period of stable interest rates that the interest rates the Bank pays on interest-bearing liabilities which consist primarily of interest-bearing deposits, will generally increase while the rates the Bank earns on loans, the principal component of the Bank's interest-earning assets, will remain fairly stable. Consequently, we projected that our net interest margin generally would continue to decrease over the twelve months ending December 31, 2007, due to competitive pricing pressure on our loans and deposits. The continued increase in non-interest-bearing funding sources (capital and demand deposits) relative to interest-bearing liabilities did have a positive effect on net interest margin in 2006.

### Noninterest Expenses

The following table presents the major components of noninterest expense for 2007, 2006 and 2005 (dollars in thousands).

	Years Ended December 31,			Dollar Change		Percent Change	
	2007	2006	2005	2007 to 2006	2006 to 2005	2007 to 2006	2006 to 2005
Salaries and employee benefits	\$ 8,992	\$ 7,543	\$ 5,373	\$ 1,449	\$ 2,170	19.21%	40.39%
Occupancy expenses	1,080	956	852	124	104	12.97%	12.21%
Other operating expenses	5,167	4,523	3,903	644	620	14.24%	15.89%
<b>Total noninterest expense</b>	<b>15,239</b>	<b>13,022</b>	<b>10,128</b>	<b>2,217</b>	<b>2,894</b>	<b>17.03%</b>	<b>28.57%</b>

The largest component of our non-interest expense, and the greatest contributing factor to the increase in non-interest expense during 2007, was the cost of salaries and employee benefits, which increased by approximately \$1,449,000 during 2007. The Bank is continuing to expand operations and construction expenses and personnel costs are expected to increase during the next eighteen to twenty-four months as we complete construction of our branches and operations center currently being built and expand to staff our new facilities and expand our support staff. The number of full-time equivalent employees increased from 150 at December 31, 2006, to 173 at December 31, 2007. The increase in other operating expenses during 2007 was primarily attributable to increases in marketing expense, professional fees and FDIC assessments of approximately \$113,000, \$101,000 and \$107,000, respectively. Marketing expense increased due to our expansion into the Blount County market. Professional fees increased due to our compliance with Sarbanes Oxley. FDIC assessment expense increased due to FDIC deposit

insurance premiums paid during 2007 as discussed in more detail above in “Supervision and Regulation - FDIC Insurance Assessments.”

The largest component of our non-interest expense, and the greatest contributing factor to the increase in non-interest expense during 2006, was the cost of salaries and employee benefits, which increased by approximately \$2,170,000 during 2006. The increase in salaries and employee benefits included normal increases in salaries, group insurance, payroll taxes, profit sharing and employee incentives along with increases directly related to an increased number of employees. The number of full-time equivalent employees increased from 131 at December 31, 2005, to 150 at December 31, 2006. Combined equipment and occupancy expenses increased from \$1,611,099 during 2005 to \$1,916,184 in 2006 due to our increase in staff and the opening of our branch office in Blount County.

### **Income Taxes**

Our provision for income taxes and effective tax rates for 2007, 2006 and 2005 were as follows:

#### **Provision for Income Taxes and Effective Tax Rates**

(dollars in thousands)	Provision	Effective Tax Rates
2007	\$ 1,294	24.86%
2006	1,295	24.95%
2005	1,454	31.76%

The Bank’s effective tax rate during 2006 and 2007 was virtually unchanged. The decrease in the effective tax rate from 2005 to 2006 and 2007 is due primarily to the tax benefits generated from the formation of MNB Real Estate, Inc., which is a real estate investment trust subsidiary formed during the second quarter of 2005. Additionally, during 2006 the Bank became a partner in Appalachian Fund for Growth II, LLC with three other Tennessee banking institutions. This partnership invested in a program that generated a federal tax credit in the amount of approximately \$200,000 per year during 2006 and 2007. Additionally, the partnership generated a single \$200,000 State of Tennessee tax credit for tax year 2006. Tax-exempt income generated from municipal bonds and bank owned life insurance also contributed to the lower effective tax rates in 2006 and 2007.

### **Discussion of Financial Condition**

#### **General Discussion of Our Financial Condition**

The following is a summary comparison of selected major components of our financial condition for the periods ended December 31, 2007 and 2006 (dollars in thousands):

	2007	2006	\$ change	% change
<b>Cash and equivalents</b>	\$ 16,329	\$ 13,396	\$ 2,933	21.89%
<b>Loans</b>	397,674	344,709	52,965	15.37%
<b>Allowance for loan losses</b>	3,974	3,524	450	12.77%
<b>Investment securities</b>	82,987	75,994	6,993	9.20%
<b>Premises and equipment</b>	25,427	19,944	5,483	27.49%
<b>Total assets</b>	541,496	469,982	71,514	15.22%
<b>Noninterest-bearing demand deposits</b>	56,307	60,016	(3,709)	-6.18%
<b>Interest-bearing demand and savings deposits</b>	139,319	130,011	9,308	7.16%
<b>Time deposits</b>	208,748	171,702	37,046	21.58%
<b>Total deposits</b>	404,374	361,729	42,645	11.79%
<b>Federal funds purchased</b>	1,300	15,575	(14,275)	-91.65%
<b>Federal Home Loan Bank advances</b>	65,356	36,710	28,646	78.03%
<b>Subordinated debentures</b>	13,403	13,403	-	0.00%
<b>Total liabilities</b>	492,548	435,571	56,977	13.08%
<b>Accumulated other comprehensive income (loss)</b>	(279)	(698)	419	-60.03%
<b>Total shareholders' equity</b>	\$ 48,948	\$ 34,411	\$ 14,537	42.25%

## Loans

At December 31, 2006 and 2007, loans comprised 80.3% and 80.8% of our total earning assets, respectively. The increase in our loan portfolio was primarily attributable to strong growth in real estate loans, including construction, commercial and residential real estate loans. Total earning assets as a percent of total assets, were 90.8% at December 31, 2007, compared to 91.3% at December 31, 2006. This decrease in total earning assets relative to total assets in 2007 was attributable to the increase in premises and equipment related to expansion and the construction of new branches and the expansion of our operations center.

Loan Portfolio. Our loan portfolio consisted of the following loan categories and amounts as of the dates indicated:

	At December 31,				
	2007	2006	2005	2004	2003
	(In Thousands)				
Commercial, financial, agricultural	\$ 35,929	\$ 26,062	\$ 15,375	\$ 9,870	\$ 10,489
Real estate - construction, development	150,844	137,989	80,719	55,618	44,086
Real estate - mortgage	201,011	173,085	144,898	134,272	119,821
Consumer and other	9,890	7,572	7,872	9,418	5,449
Less allowance for loan losses	3,974	3,524	2,634	2,281	2,142
Loans, net	\$ 393,700	\$ 341,184	\$ 246,230	\$ 206,897	\$ 177,703

Commercial and consumer loans tend to be more risky than loans that are secured by real estate, however, the Bank seeks to control this risk with strict adherence to quality underwriting standards.

**Maturities and Sensitivities of Loan Portfolio to Changes in Interest Rates.** Total loans as of December 31, 2007 are classified in the following table according to maturity or scheduled repricing:

	One year or less	Over one year through three years	Over three years through five years	Over five years
(Dollars in Thousands)				
Commercial, financial, agricultural	\$ 23,320	\$ 6,576	\$ 3,501	\$ 2,533
Real estate - construction, development	123,865	23,751	1,970	1,252
Real estate - mortgage	104,970	50,510	30,037	15,498
Consumer and other	6,604	1,994	1,040	253
Total	\$ 258,759	\$ 82,831	\$ 36,548	\$ 19,536

Of our loans maturing more than one year after December 31, 2007, approximately \$62,026,000 had fixed rates of interest and approximately \$76,889,000 had variable rates of interest. At December 31, 2007, loans to sub-dividers/developers were 14.19% of total loans. No other concentrations of credit exceeded ten percent of our total loans.

#### **Allowance for Loan Losses**

The allowance for loan losses represents management's assessment and estimates of the risks associated with extending credit and its evaluation of the quality of our loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for loan losses and the appropriate provision required to maintain the allowance for loan losses at a level believed to be adequate to absorb anticipated loan losses. In assessing the adequacy of the allowance, management reviews the size, quality and risk of loans in the portfolio. Management also considers such factors as the Bank's loan loss experience, the amount of past due and nonperforming loans, impairment of loans, specific known risks, the status and amount of nonperforming assets (including loans), underlying collateral values securing loans, current and anticipated economic conditions and other factors which affect the allowance for credit losses. The Bank's loan review officer, on a quarterly basis, prepares an analysis of the credit quality of the loan portfolio and the adequacy of the allowance for loan losses for review by our board of directors.

Our allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the level of risk in the loan portfolio. During their routine examinations of banks, regulatory agencies may advise the bank to make additional provisions to its allowance for loan losses when the opinion of the regulators regarding credit evaluations and allowance for loan loss methodology differ materially from those of the bank's management.

Concentrations of credit risk typically involve loans to one borrower, an affiliated group of borrowers, borrowers engaged in or dependent upon the same industry, or a group of borrowers whose loans are secured by the same type of collateral. Our most significant concentration of credit

risks lies in the high proportion of our loans to businesses and individuals dependent on the tourism industry. The Bank assesses loan risk by primary concentrations of credit by industry and loans directly related to the tourism industry are monitored carefully. At December 31, 2007, approximately \$179 million in loans, or 45% of total loans, were to businesses and individuals whose ability to repay depends to a significant extent on the tourism industry in the markets we serve as compared to approximately \$121 million in loans, or 35% of total loans, at December 31, 2006. The most significant increase in this category was for sub-dividers/developers which increased approximately \$19 million to approximately \$58 million, followed by hotel & motel franchise operators with an increase of approximately \$15 million to approximately \$30 million.

While it is the Bank's policy to charge off in the current period loans for which a loss is considered confirmed, there are additional risks of losses which cannot be quantified precisely or attributed to particular loans or classes of loans. Because the risk of loss includes unpredictable factors, such as the state of the economy and conditions affecting individual borrowers, management's judgments regarding the appropriate size of the allowance for loan losses is necessarily approximate and imprecise, and involves numerous estimates and judgments that may result in an allowance that is insufficient to absorb all incurred loan losses.

Management considered asset quality to be very good as of December 31, 2007. Non-accrual loans as a percentage of total loans increased from 0.00% at December 31, 2006 to 0.04% at December 31, 2007 while the ratio of nonperforming assets to total loans decreased from 0.14% at December 31, 2006 to 0.05% at December 31, 2007. Our allowance for loan losses at December 31, 2007, was approximately \$3,974,000, a net increase of approximately \$450,000 for the year. As a result of our improved asset quality during 2007, the allowance for loan losses as a percentage of total loans, non-accrual loans and non-performing assets at December 31, 2007 was 1.00%, 2,225.54% and 1,966.63%, respectively, compared to 1.02%, N/A (\$0 non-accrual loan balance) and 749.61%, respectively, at December 31, 2006. Net charge-offs during 2007 increased from approximately \$25,000 in 2006 to approximately \$532,000 in 2007, representing a net charge-off ratio of 0.15% in 2007 compared to 0.01% in 2006. Management continues to evaluate and adjust our allowance for loan losses, and presently believes the allowance for loan losses is adequate to provide for potential losses in the loan portfolio.

The recent turmoil in the credit markets caused by problems due to sub-prime loans has had very little direct impact on the Bank. The Bank does not originate sub-prime loans or purchase investments that contain sub-prime loans. The increase in net charge-offs during 2007 mentioned above included a charge-off of a loan in the amount of \$250,000 during October 2007. The sale of the property approximately thirty days later resulted in a gain on the sale of Other Real Estate Owned in the amount of approximately \$189,000, or a net loss on this property of approximately \$61,000. The original charge off of \$250,000 was appropriate based on information management had concerning the property prior to taking possession, but management underestimated the strong demand in Sevier County for the property. This loan is in the Real Estate – mortgage line in the table that summarizes our loan loss experience and related adjustments to the allowance for loan and lease losses below.

The following table sets forth, as of the dates indicated, the aggregate value of non-performing loans for the following categories:

	At December 31,				
	2007	2006	2005	2004	2003
	(Dollars in Thousands)				
Loans accounted for on a nonaccrual basis	\$ 179	\$ -	\$ 92	\$ 161	\$ 289
Loans contractually past due ninety days or more as to interest or principal payments and still accruing	19	470	342	21	1,460
Loans, the terms of which have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower	-	-	-	-	-
Loans now current about which there are serious doubts as to the ability of the borrower to comply with present loan repayment terms	170	30	95	15	182

Management is not aware of any loans classified for regulatory purposes as loss, doubtful, substandard, or special mention that have not been identified which (1) represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity, or capital resources, or (2) represent material credits about which management is aware of any information which causes management to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms.

The following table sets forth the reduction in interest income we experienced in 2006 and 2007 as a result of non-performance of certain loans during the year:

	<u>2007</u>	<u>2006</u>
Interest income that would have been recorded on nonaccrual loans under original terms	\$ 7,006	\$ 458
Interest income that was recorded on nonaccrual loans	41,397	458

The purpose of placing a loan on non-accrual is to prevent the Bank from overstating its income. The decision to place a loan on non-accrual is made by the Executive Committee based on a monthly review. The Executive Committee also reviews any loans recommended by management to be placed on non-accrual that are: (1) being maintained on a cash basis because of deterioration in the financial position of the borrower; or (2) for which payment in full of interest or principal is not expected.

Generally, the Bank does not accrue interest on any loan when principal or interest are in default for 90 days or more unless the loan is well secured and in the process of collection. Consumer loans and residential real estate loans secured by 1-4 family dwellings are ordinarily not subject to those guidelines.

The Board of Directors may restore a non-accruing loan to an accruing status when principal and interest is no longer due and unpaid, or it otherwise becomes both well secured and in the process of collection. All loans on non-accrual are reported on the Bank's watch loan list.

The following table summarizes our loan loss experience and related adjustments to the allowance for loan losses as of the dates and for the periods indicated:

	December 31,				
	2007	2006	2005	2004	2003
	(Dollars in Thousands)				
Average balance of loans outstanding	\$ 373,237	\$ 292,950	\$ 227,910	\$ 188,481	\$ 162,133
Balance of allowance for loan losses at beginning of year	3,524	2,634	2,281	2,142	1,595
Charge-offs:					
Commercial, financial, agricultural	43	-	-	-	10
Real estate - construction, development	158	1	24	-	3
Real estate - mortgage	250	25	40	325	7
Consumer and other	110	23	45	42	187
Recoveries:					
Commercial, financial, agricultural	-	-	-	-	10
Real estate - construction, development	-	1	-	17	4
Real estate - mortgage	15	18	10	21	-
Consumer and other	14	5	6	-	5
Net charge-offs	532	25	93	329	188
Additions to allowance charged to operations	982	915	446	468	735
Balance of allowance for loan losses at end of year	3,974	3,524	2,634	2,281	2,142
Ratio of net loan charge-offs during the year to average loans outstanding during the year	0.14%	0.01%	0.04%	0.17%	0.12%

The following table presents our allocation of the allowance for loan losses to the categories of loans in our loan portfolio as of the dates indicated:

	December 31,									
	2007		2006		2005		2004		2003	
	Amount	Loan Category as % of Total Loans	Amount	Loan Category as % of Total Loans	Amount	Loan Category as % of Total Loans	Amount	Loan Category as % of Total Loans	Amount	Loan Category as % of Total Loans
	(Dollars in Thousands)									
Commercial	\$ 968	9.03%	\$ 418	7.56%	\$ 225	3.16%	\$ 226	4.72%	\$ 261	5.83%
Real estate - construction, development	\$ 1,600	37.93%	\$ 1,331	40.03%	\$ 837	32.43%	\$ 584	26.59%	\$ 495	24.51%
Real estate - mortgage	1,201	50.55%	1,669	50.21%	1,502	58.23%	1,411	64.19%	1,347	66.63%
Consumer, other	205	2.49%	106	2.20%	70	6.18%	60	4.50%	39	3.03%
Total	\$ 3,974	100.00%	\$ 3,524	100.00%	\$ 2,634	100.00%	\$ 2,281	100.00%	\$ 2,142	100.00%

## Securities

Our investment securities portfolio consists of securities of U.S. government agencies, mortgage-backed securities and municipal securities. The investment securities portfolio is the second largest component of our earning assets and represented 16.87% of total earning assets and 15.33% of total assets at year-end 2007. As an integral component of our asset/liability management strategy, we manage our investment securities portfolio to maintain liquidity, balance interest rate risk and augment interest income. We also use our investment securities portfolio to meet pledging requirements for deposits and borrowings. The average yield on our investment securities portfolio during 2007 was 4.92% versus 4.77% for 2006, an increase of 15

basis points. Net unrealized losses on securities available for sale, included in accumulated other comprehensive income/(loss), decreased by \$418,747, net of income taxes, during 2007.

The growth in our investment securities portfolio during 2007 was attributable to deposit inflows of public funds that are required to be collateralized with these investments that we invested in U.S. government securities. The average yields on these investments generally exceeded the cost of the interest-bearing deposits and borrowings that funded them during 2007. Included in our investment securities portfolio as of December 31, 2007, was approximately \$15,855,000 in tax-exempt municipal securities.

The carrying amounts of securities at the dates indicated are summarized as follows:

	December 31,		
	2007	2006	2005
(Dollars in Thousands)			
<b>Securities available for sale:</b>			
U.S. Treasury and government agencies and corporations .....	\$9,179	\$9,535	\$6,502
Mortgage-backed securities.....	57,975	51,367	40,851
Obligations of states and political subdivisions .....	13,812	13,612	9,663
Total .....	80,966	74,514	57,016
<b>Securities held to maturity:</b>			
Obligations of states and political subdivisions .....	2,021	1,480	1,411

The following table contains the contractual maturity distribution, carrying value, and weighted-average yield to maturity of our investment securities.

**Maturity**

	<b>Weighted</b>	<b>After 1</b>	<b>Weighted</b>	<b>After 5</b>	<b>Weighted</b>		<b>Weighted</b>		<b>Weighted</b>
<b>1 year</b>	<b>Average</b>	<b>Year - 5</b>	<b>Average</b>	<b>Years - 10</b>	<b>Average</b>	<b>Over 10</b>	<b>Average</b>	<b>Total</b>	<b>Average</b>
<b>or less</b>	<b>Yield</b>	<b>5 Years</b>	<b>Yield</b>	<b>Years</b>	<b>Yield</b>	<b>Years</b>	<b>Yield</b>		<b>Yield</b>

(dollars in thousands)

**Available for Sale:**

U.S. Treasury and										
Government Agencies	\$ 250	4.32%	\$ 2,503	5.37%	\$ 2,428	4.69%	\$ 3,998	5.06%	\$ 9,179	5.03%
Mortgage-Backed Securities	-	-	-	-	11,551	5.37%	46,424	5.09%	57,975	5.14%
Obligations of State and										
Political Subdivisions	<u>311</u>	<u>4.58%</u>	<u>1,421</u>	<u>4.81%</u>	<u>3,700</u>	<u>5.94%</u>	<u>8,380</u>	<u>5.69%</u>	<u>13,812</u>	<u>5.64%</u>
Total Available for Sale	561	4.46%	3,924	5.17%	17,679	5.40%	58,802	5.17%	80,966	5.22%

**Held to Maturity:**

U.S. Treasury and										
Government Agencies	-	-	-	-	-	-	-	-	-	
Mortgage-Backed Securities	-	-	-	-	-	-	-	-	-	
Obligations of State and										
Political Subdivisions	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>2,021</u>	<u>8.95%</u>	<u>2,021</u>	<u>8.95%</u>
Total Held to Maturity	-	0.00%	-	0.00%	-	0.00%	2,021	8.95%	2,021	8.95%
<b>Total Securities</b>	561	4.46%	3,924	5.17%	17,679	5.40%	60,823	5.30%	82,987	5.31%

We did not hold any securities from a single issuer that exceeded 10% of total shareholders' equity as of December 31, 2007, except for securities of the U.S. Government or U.S. Government agencies except for mortgage-backed securities issued by government sponsored entities that had a carrying value of approximately \$57,975,000 and \$51,368,000 at December 31, 2007 and 2006, respectively.

**Deposits**

Asset growth during 2007 was funded primarily by the increase in deposits and FHLB advances for the periods ended December 31, 2007 and 2006.

The balances in total deposits was distributed as follows:

	<b>2007</b>	<b>2006</b>	<b>\$ change</b>	<b>% change</b>
<b>Noninterest-bearing demand deposits</b>	\$ 56,307	\$ 60,016	\$ (3,709)	-6.18%
<b>Total noninterest-bearing deposits</b>	56,307	60,016	(3,709)	-6.18%
<b>NOW Accounts</b>	87,380	76,070	11,310	14.87%
<b>Money market accounts</b>	42,959	45,667	(2,708)	-5.93%
<b>Savings</b>	8,980	8,275	705	8.52%
<b>Brokered Deposits</b>	48,210	51,379	(3,169)	-6.17%
<b>Time deposits</b>	<u>160,538</u>	<u>120,322</u>	<u>40,216</u>	<u>33.42%</u>
<b>Total interest-bearing deposits</b>	348,067	301,713	46,354	15.36%
<b>Total deposits</b>	\$ 404,374	\$ 361,729	\$ 42,645	11.79%

Brokered deposits are certificates of deposit acquired from approved brokers on terms that are substantially similar to deposits acquired in the local market. Brokered deposits decreased approximately \$3 million at December 31, 2007 as compared to December 31, 2006. The Bank will continue to rely upon these brokered deposits going forward due to the increasing loan demand, the relative ease at which these deposits can be acquired and replaced upon maturity and their comparability to local market rates. The average cost of our brokered deposits at December 31, 2007 was 5.03%. During 2008, maturing brokered deposits are being replaced at an average rate of 3.50%, a 153 basis point decrease over the 2007 average, with maturities ranging from 12 to 24 months.

The average balances of deposit accounts by category and the average rates paid thereon are presented below for the periods indicated:

	<u>2007</u>		<u>2006</u>		<u>2005</u>	
	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>
	(Dollars in Thousands)					
Non-interest-bearing demand deposits	\$53,336	0%	\$54,163	0%	\$46,187	0%
Interest-bearing demand deposits	127,704	3.88%	120,268	3.72%	98,356	2.18%
Savings deposits	8,673	1.05%	7,860	0.61%	6,764	0.59%
Time deposits	<u>196,654</u>	5.10%	<u>146,014</u>	4.28%	<u>117,415</u>	2.98%
Total	<u>\$386,367</u>		<u>\$328,305</u>		<u>\$268,722</u>	

The balances in time certificates of deposit issued in amounts of \$100,000 or more as of December 31, 2007, are shown below by time remaining until maturity:

	<u>(Dollars in Thousands)</u>
Three months or less.....	\$43,130
Over three months through six months.....	33,442
Over six months through 12 months.....	28,672
Over 12 months.....	<u>31,894</u>
Total.....	\$137,138

The average balance of interest-bearing demand and savings deposits increased approximately \$8,249,000 during 2007. The average rate paid on these interest-bearing demand and savings deposits in 2007 was 3.70% up from 3.53% in 2006.

We also continue to experience high demand for our certificate of deposit accounts. We offer certificate of deposit accounts on a wide range of terms in order to achieve sustained growth in a market area where there is strong competition for new deposits. Our total average cost of interest-bearing deposits (including demand, savings and certificate of deposit accounts) for 2007 was 4.53%, up from 3.93% in the prior year.

## Shareholders' Equity

The increase in shareholders' equity was primarily the result of the exercise of stock options and warrants, as discussed in more detail under "Item 1 – Business," as well as the increase in net earnings of approximately \$3,912,000. Accumulated other comprehensive loss, which represents the net unrealized losses on securities available-for-sale, decreased approximately \$419,000 during 2007 to approximately \$279,000.

### **Interest Rate Sensitivity Management**

Interest rate risk is the risk to earnings or market value of equity from the potential movement in interest rates. The primary purpose of managing interest rate risk is to reduce the effects of interest rate volatility and achieve reasonable stability of earnings from changes in interest rates and preserve the value of our equity. Changes in interest rates affect, among other things, our net interest income, volume of loan production and the fair value of financial instruments and our loan portfolio. A key component of our interest rate risk management policy is the maintenance of an appropriate mix of assets and liabilities.

It is our objective to manage assets and liabilities to control the impact of interest rate fluctuations on earnings and to provide a satisfactory, consistent level of profitability within the framework of established cash, loan, investment, borrowing, and capital policies. Certain officers within the Bank are charged with the responsibility for monitoring policies and procedures that are designed to ensure acceptable composition of the asset/liability mix.

The Bank's asset/liability mix is monitored on a regular basis and a report reflecting the interest rate sensitive assets and interest rate sensitive liabilities is prepared and presented to our Board of Directors and management's asset/liability committee on a quarterly basis. The key objective of our asset/liability management policy is to monitor and adjust the mix of interest rate sensitive assets and liabilities so as to minimize the impact of substantial movements in interest rates on earnings by matching rates and maturities of our interest-earning assets to those of our interest-bearing liabilities. An asset or liability is considered to be interest rate-sensitive if it will reprice or mature within the time period analyzed, usually one year or less.

We use interest rate sensitivity gap analysis to achieve the appropriate mix of interest rate-sensitive assets and liabilities. The interest rate-sensitivity gap is the difference between the interest-earning assets and interest-bearing liabilities scheduled to mature or reprice within a given time period. A gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities. A gap is considered negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to adversely affect net interest income. If our assets and liabilities were equally flexible and moved concurrently, the impact of any increase or decrease in interest rates on net interest income would be minimal.

A simple interest rate "gap" analysis by itself may not be an accurate indicator of how net interest income will be affected by changes in interest rates. Accordingly, we also evaluate how the repayment of particular assets and liabilities is impacted by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may

not be affected uniformly by changes in interest rates. In addition, unpredictable variables such as the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types of assets and liabilities may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as "interest rate caps"), that limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the interest rate gap.

The following table summarizes our interest-sensitive assets and liabilities as of December 31, 2007. Adjustable rate loans are included in the period in which their interest rates are scheduled to adjust. Fixed rate loans are included in the periods in which they are anticipated to be repaid based on scheduled maturities and anticipated prepayments. Investment securities are included in the period in which they are scheduled to mature while mortgage backed securities are included according to expected repayment. Certificates of deposit are presented according to contractual maturity dates.

**Analysis of Interest Sensitivity**  
**As of December 31, 2007**  
**(Dollars in Thousands)**

	<u>0 - 3</u> <u>Months</u>	<u>3 - 12</u> <u>Months</u>	<u>1 - 3</u> <u>Years</u>	<u>Over 3</u> <u>Years</u>	<u>Total</u>
Federal funds sold	\$3,317	\$0	\$0	\$0	\$3,317
Securities	2,876	8,108	20,821	51,182	82,987
Loans (1)	205,414	70,177	77,463	44,620	397,674
Total interest-earning assets	<u>\$211,607</u>	<u>\$78,285</u>	<u>\$98,284</u>	<u>\$95,802</u>	<u>\$483,978</u>
Interest-bearing liabilities:					
Interest-bearing demand deposits	130,339	0	0	0	130,339
Savings	8,980	0	0	0	8,980
Time deposits	59,772	107,446	31,227	10,303	208,748
Other borrowings	6,742	7,456	7,700	50,200	72,098
Total interest-bearing liabilities	<u>\$200,391</u>	<u>\$114,902</u>	<u>\$38,927</u>	<u>\$60,503</u>	<u>\$414,723</u>
Interest rate sensitivity gap	<u>\$11,216</u>	<u>\$(36,617)</u>	<u>\$59,357</u>	<u>\$35,299</u>	<u>\$69,255</u>
Cumulative interest rate sensitivity gap	<u>\$11,216</u>	<u>\$(25,401)</u>	<u>\$33,956</u>	<u>\$69,255</u>	
Interest rate sensitivity gap ratio	<u>5.30%</u>	<u>(46.77%)</u>	<u>60.39%</u>	<u>36.85%</u>	
Cumulative interest rate sensitivity gap ratio	5.30%	(8.76%)	8.75%	14.31%	

(1) Includes nonaccrual loans.

In the last four months of 2007 the Federal Reserve reduced the targeted federal funds rate three times, for a total of 1.00% and reduced the discount rate four times during the last five months of 2007, for a total of 1.50%.

At December 31, 2007, the Bank's cumulative one-year interest rate sensitivity gap ratio was (8.76%), which would tend to indicate that our interest-earning assets will re-price during this period at a rate slower than our interest-bearing liabilities. However, in our experience, not all liabilities shown in our gap analysis as being subject to repricing during a given period will in fact experience significant repricing even as market rates change. For example, we have a base of core deposits consisting of interest-bearing checking accounts, money market accounts and passbook savings accounts whose average balances and interest rates paid generally fluctuate very little with changes in the levels of market interest rates. Consequently, these relatively static interest-bearing liabilities, while sensitive to market interest rates and therefore included in our interest rate sensitivity gap analysis, tend to have a much greater effect on our gap analysis than they do on our actual net interest margin. More than \$61 million of the deposits reflected in the table above as repricing within the first three months of 2008 fall into this category of interest-bearing liabilities that have low interest rate variability relative to changes in market rates of interest. Because the effects of these categories of interest-bearing liabilities tends to be overstated in our gap analysis, we believe that the spread between our interest-earning assets and interest-bearing liabilities will not be affected as much by the repricing period for these deposits as they will by the current interest rate environment. Generally, the interest rates we are required to pay on these interest-bearing deposit accounts will not decrease at the same rate as the interest rates we earn on loans.

### **Return on Assets and Equity**

The following table summarizes our return on average assets and return on average equity as well as our dividend payout ratio for the years ended December 31, 2007, 2006 and 2005:

	For the Years Ended		
	December 31,		
	2007	2006	2005
Return on Average Assets .....	0.77%	0.95%	0.98%
Return on Average Equity .....	9.81%	11.26%	16.87%
Average Equity as a Percentage of Average Assets.....	7.83%	8.48%	5.79%
Dividend Payout Ratio.....	0.00%	0.00%	0.00%

### **Capital Adequacy and Liquidity**

Our funding sources primarily include customer-based core deposits and customer repurchase accounts. The Bank, being situated in a market that relies on tourism as its principal industry, can be subject to periods of reduced deposit funding because tourism in Sevier County is seasonably slow in the winter months. The Bank manages seasonal deposit outflows through its secured Federal Funds lines of credit at several correspondent banks. Those lines totaled \$39 million as of December 31, 2007, and are available on one day's notice. The Bank also has a cash management line of credit in the amount of \$100 million from the FHLB of Cincinnati that the Bank uses to meet short-term liquidity demands.

Capital adequacy is important to the continued financial safety and soundness and growth of the Bank and the Company. Our banking regulators have adopted risk-based capital and leverage guidelines to measure the capital adequacy of national banks and bank holding companies. Based on these guidelines, management believes the Bank and the Company are “well capitalized.”

### Regulatory Capital Requirements

The Bank is subject to minimum capital standards as set forth by federal bank regulatory agencies.

The Bank’s capital for regulatory purposes differs from the Bank’s equity as determined under generally accepted accounting principles. Generally, “Tier 1” regulatory capital will equal capital as determined under generally accepted accounting principles less any unrealized gains or losses on securities available for sale, while “Tier 2” capital includes the allowance for loan losses up to certain limitations. Total risk based capital is the sum of Tier 1 and Tier 2 capital. :

Total capital at the Bank also has an important effect on the amount of FDIC insurance premiums paid. Institutions not considered well capitalized are subject to higher rates for FDIC insurance.

The table below sets forth the Bank’s capital ratios as of the periods indicated:

	<u>December 31, 2007</u>	<u>December 31, 2006</u>
Tier 1 Risk-Based Capital	13.10%	11.33%
Regulatory Minimum	4.00	4.00
Well-capitalized	6.00	6.00
Total Risk-Based Capital	13.97%	12.22%
Regulatory Minimum	8.00	8.00
Well-capitalized	10.00	10.00
Tier 1 Leverage	11.24%	9.99%
Regulatory Minimum	4.00	4.00
Well-capitalized	5.00	5.00

In November 2003, the Company formed a wholly owned Delaware statutory trust subsidiary, MNB Capital Trust I. This subsidiary issued approximately \$5.5 million in trust preferred securities, guaranteed by the Company on a junior subordinated basis. In June 2006, the Company formed a wholly owned Delaware statutory trust subsidiary, MNB Capital Trust II. This subsidiary issued approximately \$7.5 million in trust preferred securities, guaranteed by the Company on a junior subordinated basis. The Company obtained the proceeds from the trusts’ sale of trust preferred securities by issuing junior subordinated debentures to the trusts. Under the Financial Accounting Standards Board’s revised Interpretation No. 46 (“FIN 46R”), the trust subsidiaries must be deconsolidated with the Company for accounting purposes. As a result of this accounting pronouncement, the Federal Reserve Board adopted changes to its capital rules with respect to the regulatory capital treatment afforded to trust preferred securities. The Federal Reserve Board’s current rules permit qualified trust preferred securities and other restricted

capital elements to be included as Tier 1 capital up to 25% of core capital, net of goodwill and intangibles. The Company believes that its trust preferred securities qualify under these revised regulatory capital rules and expects that it will continue to treat the eligible portion of its \$13 million of trust preferred securities as Tier 1 capital.

The Company's sale of 416,500 shares of common stock during the third quarter of 2005 resulted in an increase in capital of approximately \$9,896,500. In connection with the offering, there were 416,500 warrants issued, one warrant for each share of stock sold, that had an exercise price of \$25.20 per warrant. The warrants could be exercised beginning after one year from the date of the sale of the common stock, and had to be exercised no later than two years from the date of the sale. The final day to exercise the common stock warrants was September 7, 2007. During their one year outstanding, 476,194 out of 482,151 (adjusted for 5% stock dividends) warrants were exercised at a weighted average exercise price of \$21.77 (adjusted for 5% stock dividends). The total corresponding increase to shareholders' equity from September 30, 2006 to September 30, 2007, was approximately \$10,367,000. The increase in shareholder's equity should keep both the Company and the Bank well-capitalized under regulatory standards and allow for future growth for approximately three to five years.

Liquidity is the ability of a company to convert assets into cash or cash equivalents without significant loss. Our liquidity management involves maintaining our ability to meet the day-to-day cash flow requirements of our customers, whether they are depositors wishing to withdraw funds or borrowers requiring funds to meet their credit needs. Without proper liquidity management, we would not be able to perform the primary function of a financial intermediary and would, therefore, not be able to meet the production and growth needs of the communities we serve.

The primary function of asset and liability management is not only to assure adequate liquidity in order for us to meet the needs of our customer base, but also to maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities so that we can also meet the investment objectives of our shareholders. For additional information relating to our interest rate sensitivity management, refer to the discussion above under the heading "Interest Rate Sensitivity Management." Daily monitoring of the sources and uses of funds is necessary to maintain an acceptable cash position that meets both the needs of our customers and the objectives of our shareholders. In a banking environment, both assets and liabilities are considered sources of liquidity funding and both are therefore monitored on a daily basis.

### **Off-Balance Sheet Arrangements**

Our only material off-balance sheet arrangements consist of commitments to extend credit and standby letters of credit issued in the ordinary course of business to facilitate customers' funding needs or risk management objectives.

### **Commitments and Lines of Credit**

In the ordinary course of business, the Bank has granted commitments to extend credit and standby letters of credit to approved customers. Generally, these commitments to extend credit have been granted on a temporary basis for seasonal or inventory requirements and have been approved by the Bank's loan committee. These commitments are recorded in the financial

statements as they are funded. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitment amounts expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The following is a summary of the Bank's commitments outstanding at December 31, 2007 and 2006.

	<u>2007</u>	<u>2006</u>
	(Dollars in thousands)	
Commitments to extend credit.....	\$125,475	\$110,963
Standby letters of credit.....	<u>5,824</u>	<u>12,250</u>
Totals	\$131,299	\$123,213

Commitments to extend credit include unused commitments for open-end lines secured by 1-4 family residential properties, commitments to fund loans secured by commercial real estate, construction loans, land development loans, and other unused commitments. Commitments to fund commercial real estate, construction, and land development loans increased approximately \$6,939,000 during 2007. This increase in commitments from 2006 to 2007 was due to the continued increase in the development of property in Sevier County, and our success in attracting new customers.

### **Effects of Inflation**

Our consolidated financial statements and related data presented herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operational results in terms of historic dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Inflation generally increases the costs of funds and operating overhead, and to the extent loans and other assets bear variable rates, the yields on such assets. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates generally have a more significant effect on the performance of a financial institution than the effects of general levels of inflation. In addition, inflation affects financial institutions' cost of goods and services purchased, the cost of salaries and benefits, occupancy expense, and similar items. Inflation and related increases in interest rates generally decrease the market value of investments and loans held and may adversely affect liquidity, earnings, and stockholders' equity. Mortgage originations and refinancings tend to slow as interest rates increase, and likely will reduce the Bank's volume of such activities and the income from the sale of residential mortgage loans in the secondary market.

### **Significant Accounting Changes**

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140." ("SFAS 155") SFAS 155 permits, but does not require, fair value accounting for hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." ("SFAS 133") SFAS 155 also eliminated the temporary exemption for interests in securitized financial assets provided for by SFAS 133, Derivatives Implementation Group ("DIG") Issue D1, "Application of Statement 133 to

Beneficial Interests in Securitized Financial Assets.” The FASB issued interpretive guidance in SFAS 133 during January 2007, DIG Issue B40, “Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets,” in which the FASB concluded that a securitized interest in prepayable financial assets was not subject to the bifurcation requirements of SFAS 155 when the interest met both of the following criteria: (1) the right to accelerate the settlement of the securitized interest cannot be controlled by the investor; and (2) the securitized interest itself does not contain an embedded derivative for which bifurcation would be required other than embedded derivative that results solely from the embedded call options in the underlying financial assets. SFAS 155 is effective for all financial instruments acquired or issued after December 31, 2006 as well as to those hybrid financial instruments that had been previously bifurcated under SFAS 133. The guidance in DIG Issue B40 is effective upon the adoption of SFAS 155. As of December 31, 2007, the Company did not have any hybrid financial instruments that were previously bifurcated under SFAS 133 and the guidance provided for in DIG Issue B40 allowed the Company to continue to purchase mortgage-backed securities without applying the bifurcation requirements of SFAS 155. The adoption of SFAS 155 and DIG Issue B40 did not have a material impact on the Company’s financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The impact of adoption was not material.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard is effective for the Company on January 1, 2008. The Company did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008.

The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”), as of January 1, 2007. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. The adoption had no effect on the Company’s financial statements.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants’ employment

or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue is effective for fiscal years beginning after December 15, 2007. The impact of adoption was not material.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-5, *Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 (Accounting for Purchases of Life Insurance)* (“EITF 06-5”). This Issue requires that a policyholder consider contractual terms of a life insurance policy in determining the amount that could be realized under the insurance contract. It also requires that if the contract provides for a greater surrender value if all individual policies in a group are surrendered at the same time, that the surrender value be determined based on the assumption that policies will be surrendered on an individual basis. Lastly, the Issue requires disclosure when there are contractual restrictions on the Company’s ability to surrender a policy. The adoption of EITF 06-5 on January 1, 2007 had no impact on the Company’s financial condition or results of operation.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The consolidated financial statements of the Company, including notes thereto, and the reports of the Company’s independent registered public accounting firm are included in this Annual Report on Form 10-K beginning at page F-1 and are incorporated herein by reference.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A(T). CONTROLS AND PROCEDURES**

### **Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports and other information filed with the Commission, under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms, and that such information is accumulated and communicated to the management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

The Company carried out an evaluation, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon the foregoing, the Chief Executive Officer along with the Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective.

### **Changes in Internal Control over Financial Reporting**

During the fourth quarter of 2007 there were no changes in the Company's internal control over financial reporting that have materially affected, or that are reasonably likely to materially affect, the Company's internal control over financial reporting.

### **Management's Annual Report on Internal Control over Financial Reporting**

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting. Internal control is designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation of reliable published financial statements. Internal control over financial reporting includes self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Because of inherent limitations in any system of internal control, no matter how well designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the Company's internal control over financial reporting as of December 31, 2007. This assessment was based on criteria for effective internal control over financial reporting described in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, the Chief Executive Officer and Chief Financial Officer concluded that the Company maintained effective internal control over financial reporting as of December 31, 2007 based on the specified criteria.

This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

### **ITEM 9B. OTHER INFORMATION**

None.

## **PART III**

### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information appearing under the headings "Proposal #1 Election of Directors," "Additional Information Concerning the Company's Board of Directors and Committees" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement (the "2008 Proxy Statement") relating to the annual meeting of shareholders of the Company, scheduled to be held on May 6, 2008, is incorporated herein by reference.

## **ITEM 11. EXECUTIVE COMPENSATION**

The information appearing under the heading "Proposal #1 Election of Directors" and "Compensation of Named Executive Officers and Directors" in the 2008 Proxy Statement is incorporated herein by reference.

## **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information appearing under the heading "Outstanding Voting Securities of the Company and Principal Holders Thereof" in the 2008 Proxy Statement is incorporated herein by reference.

The information appearing under "Note 14. Stock Options and Warrants" in the 2007 notes to the financial statements is incorporated herein by reference.

## **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information appearing under the headings "Certain Relationships and Transactions" and "Proposal #1 Election of Directors" in the 2008 Proxy Statement is incorporated herein by reference.

## **ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information appearing under the caption "Proposal #2 - Ratification of Independent Registered Public Accounting Firm" in the 2008 Proxy Statement is incorporated herein by reference.

## **PART IV**

## **ITEM 15. EXHIBITS**

(a) The following exhibits are filed as a part of or incorporated by reference in this report:

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
2.1	Plan of Reorganization dated March 28, 2003, by and between the Registrant and Mountain National Bank (included as Exhibit 2.1 to the Report on Form 8-K12G3 of the Registrant, dated July 12, 2003 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference).
2.2	Amendment to Plan of Reorganization dated July 1, 2003 (included as Exhibit 2.2 to the Report on Form 8-K12G3 of the Registrant, dated July 12, 2003 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference).

- 3.1 Charter of Incorporation of the Registrant, as amended (included as Exhibit 3.1 to the Report on Form 8-K of the Registrant, dated May 19, 2006 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference).
- 3.2 Bylaws of the Registrant, as amended (included as Exhibit 3.2 to the Report on Form 8-K of the Registrant, dated May 19, 2006 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference).
- 10.1 Stock Option Plan of the Registrant, as amended (included as Exhibit 10.1 to the Report on Form 8-K of the Registrant, dated May 19, 2006 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference)\*
- 10.2 Stock Option Agreement of Dwight B. Grizzell (assumed by Registrant) (included as Exhibit 10.3 to the Registrant's Form 10-KSB for the year ended December 31, 2002 and incorporated herein by reference)\*
- 10.3 Summary Description of Director and Named Executive Officer Compensation Arrangements\*
- 10.4 Form of Warrant Agreement (included as Exhibit 10.5 to the Registrant's Form SB-2/A filed with the Commission on August 23, 2005)
- 10.5 Employment Agreement dated as of May 18, 2006 by and between Mountain National Bancshares, Inc. and Dwight Grizzell (included as Exhibit 10.2 to the Report on Form 8-K of the Registrant, dated May 19, 2006 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference)\*
- 10.6 Employment Agreement dated as of May 18, 2006 by and between Mountain National Bancshares, Inc. and Grace McKinzie (included as Exhibit 10.3 to the Report on Form 8-K of the Registrant, dated May 19, 2006 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference)\*
- 10.7 Employment Agreement dated as of May 18, 2006 by and between Mountain National Bancshares, Inc. and Michael Brown (included as Exhibit 10.4 to the Report on Form 8-K of the Registrant, dated May 19, 2006 (File No. 000-49912), previously filed with the Commission and incorporated herein by reference)\*
- 10.8 Amended and Restated Salary Continuation Agreement, dated January 19, 2007, by and between Mountain National Bank and Dwight Grizzell.\*
- 10.9 Amendment, dated November 19, 2007, to Amended and Restated Salary

- Continuation Agreement, by and between Mountain National Bank and Dwight Grizzell.\*
- 10.10 Amended and Restated Salary Continuation Agreement, dated January 19, 2007, by and between Mountain National Bank and Michael Brown.\*
- 10.11 Amendment, dated November 19, 2007, to Amended and Restated Salary Continuation Agreement, by and between Mountain National Bank and Michael Brown.\*
- 10.12 Amended and Restated Salary Continuation Agreement, dated January 19, 2007, by and between Mountain National Bank and Grace McKinzie.\*
- 10.13 Amendment, dated November 19, 2007, to Amended and Restated Salary Continuation Agreement, by and between Mountain National Bank and Grace McKinzie.\*
- 21 Subsidiaries of the Registrant
- 23 Consent of Independent Registered Public Accounting Firm
- 31.1 Certificate of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certificate of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certificate of CEO pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certificate of CFO pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Denotes management contract or compensatory plan or arrangement.

The Company is a party to certain agreements entered into in connection with the offering by MNB Capital Trust I of an aggregate of \$5,500,000 in trust preferred securities and the offering by MNB Capital Trust II of an aggregate of \$7,500,000 in trust preferred securities, as more fully described in this Annual Report on Form 10-K. In accordance with Item 601(b)(4)(iii) of Regulation S-K, and because the total amount of the trust preferred securities is not in excess of 10% of the Company's total assets, the Company has not filed the various documents and agreements associated with the trust preferred securities herewith. The Company has, however, agreed to furnish copies of the various documents and agreements associated with the trust preferred securities to the Commission upon request.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MOUNTAIN NATIONAL BANCSHARES, INC.  
(Registrant)

By:           /s/ Dwight B. Grizzell            
Dwight B. Grizzell  
President and Chief Executive Officer  
Date: March 31, 2008

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

          /s/ Dwight B. Grizzell                    Date: March 31, 2008  
Dwight B. Grizzell, President,  
Chief Executive Officer and Director

          /s/ Richard A. Hubbs                    Date: March 31, 2008  
Richard A. Hubbs, Senior Vice President and  
Chief Financial Officer

          /s/ James E. Bookstaff                    Date: March 31, 2008  
James E. Bookstaff, Director

          /s/ Gary A. Helton                    Date: March 31, 2008  
Gary A. Helton, Director

          /s/ Charlie R. Johnson                    Date: March 31, 2008  
Charlie R. Johnson, Director

          /s/ Sam L. Large                    Date: March 31, 2008  
Sam L. Large, Director

/s/ Jeffrey J. Monson  
Jeffrey J. Monson, Director

Date: March 31, 2008

/s/ Linda N. Ogle  
Linda N. Ogle, Director

Date: March 31, 2008

/s/ Michael C. Ownby  
Michael C. Ownby, Director

Date: March 31, 2008

/s/ John R. Parker  
John R. Parker, Director

Date: March 31, 2008

/s/ Ruth Reams  
Ruth Reams, Director

Date: March 31, 2008

## **EXHIBIT 21**

### **Subsidiaries of the Company:**

Mountain National Bank, a national banking association  
MNB Capital Trust I, a Delaware statutory trust  
MNB Capital Trust II, a Delaware statutory trust  
MNB Holdings, Inc., a Tennessee corporation  
MNB Investments, Inc., a Nevada corporation  
MNB Real Estate, Inc., a Maryland corporation

## EXHIBIT 31.1

### CERTIFICATIONS

I, Dwight B. Grizzell, certify that:

1. I have reviewed this annual report on Form 10-K of Mountain National Bancshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the

audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 31, 2008

/s/ Dwight B. Grizzell  
Dwight B. Grizzell  
President and Chief Executive Officer

**CERTIFICATIONS**

I, Rick Hubbs, certify that:

1. I have reviewed this annual report on Form 10-K of Mountain National Bancshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the



**EXHIBIT 32.1**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Mountain National Bancshares, Inc. (the "Company") on Form 10-K for the period ended December 31, 2007 (the "Report"), I, Dwight B. Grizzell, Chief Executive Officer of the Company, do hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 31, 2008

/s/ Dwight B. Grizzell  
Dwight B. Grizzell, Chief Executive Officer

**EXHIBIT 32.2**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Mountain National Bancshares, Inc. (the "Company") on Form 10-K for the period ended December 31, 2007 (the "Report"), I, Rick Hubbs, Senior Vice President and Chief Financial Officer of the Company, do hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 31, 2008

/s/ Richard A. Hubbs  
Richard A. Hubbs, Senior Vice President and  
Chief Financial Officer

**END**