

AMERICAN NATIONAL BANKSHARES INC.  
Form 10-Q  
May 12, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED March 31, 2014.

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

Commission file number: 0-12820

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

VIRGINIA 54-1284688  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

628 Main Street  
Danville, Virginia 24541  
(Address of principal executive offices) (Zip Code)

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

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

YesxNoo

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

YesxNoo

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

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

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

YesoNox

At April 30, 2014, the Company had 7,905,243 shares of Common Stock outstanding, \$1 par value.

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## Part I. Financial Information

## Item 1. Financial Statements

## American National Bankshares Inc. and Subsidiaries

## Consolidated Balance Sheets

(Dollars in thousands, except share data)

|   | (Unaudited)<br>March 31,<br>2014 | (Audited)<br>December<br>31, 2013 |
|---|----------------------------------|-----------------------------------|
| <b>Assets</b>   |                                  |                                   |
| Cash and due from banks   | \$25,880                         | \$19,808                          |
| Interest-bearing deposits in other banks  | 45,466                           | 47,873                            |
| Securities available for sale, at fair value  | 349,123                          | 346,124                           |
| Restricted stock, at cost   | 4,529                            | 4,889                             |
| Loans held for sale   | 1,389                            | 2,760                             |
| Loans, net of unearned income   | 783,369                          | 794,671                           |
| Less allowance for loan losses  | (12,614 )                        | (12,600 )                         |
| Net loans   | 770,755                          | 782,071                           |
| Premises and equipment, net   | 23,359                           | 23,674                            |
| Other real estate owned, net  | 3,233                            | 3,422                             |
| Goodwill  | 39,043                           | 39,043                            |
| Core deposit intangibles, net   | 2,828                            | 3,159                             |
| Bank owned life insurance   | 14,845                           | 14,746                            |
| Accrued interest receivable and other assets  | 19,352                           | 19,943                            |
| Total assets  | \$1,299,802                      | \$1,307,512                       |
| <b>Liabilities</b>  |                                  |                                   |
| <b>Liabilities:</b>   |                                  |                                   |
| Demand deposits -- noninterest bearing  | \$218,795                        | \$229,347                         |
| Demand deposits -- interest bearing   | 170,894                          | 167,736                           |
| Money market deposits   | 194,528                          | 185,270                           |
| Savings deposits  | 89,024                           | 85,724                            |
| Time deposits   | 378,008                          | 389,598                           |
| Total deposits  | 1,051,249                        | 1,057,675                         |
| Customer repurchase agreements  | 34,153                           | 39,478                            |
| Long-term borrowings  | 9,919                            | 9,951                             |
| Trust preferred capital notes   | 27,444                           | 27,419                            |
| Accrued interest payable and other liabilities  | 6,538                            | 5,438                             |
| Total liabilities   | 1,129,303                        | 1,139,961                         |
| <b>Shareholders' equity</b>   |                                  |                                   |
| Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding   | -                                | -                                 |
| Common stock, \$1 par, 20,000,000 shares authorized, 7,905,243 shares outstanding at March 31, 2014 and 7,890,697 shares outstanding at December 31, 2013 | 7,905                            | 7,891                             |
| Capital in excess of par value  | 58,202                           | 58,050                            |
| Retained earnings   | 100,721                          | 99,090                            |

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|   |             |             |
|---|-------------|-------------|
| Accumulated other comprehensive income, net | 3,671       | 2,520       |
| Total shareholders' equity                  | 170,499     | 167,551     |
| Total liabilities and shareholders' equity  | \$1,299,802 | \$1,307,512 |

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

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

|   | Three Months Ended<br>March 31 |          |
|---|--------------------------------|----------|
|   | 2014                           | 2013     |
| Interest and Dividend Income:                       |                                |          |
| Interest and fees on loans                          | \$9,847                        | \$11,395 |
| Interest and dividends on securities:               |                                |          |
| Taxable   | 964                            | 878      |
| Tax-exempt  | 1,035                          | 1,052    |
| Dividends   | 75                             | 55       |
| Other interest income                               | 33                             | 29       |
| Total interest and dividend income                  | 11,954                         | 13,409   |
| Interest Expense:                                   |                                |          |
| Interest on deposits                                | 1,229                          | 1,436    |
| Interest on short-term borrowings                   | 2                              | 21       |
| Interest on long-term borrowings                    | 80                             | 82       |
| Interest on trust preferred capital notes           | 184                            | 188      |
| Total interest expense                              | 1,495                          | 1,727    |
| Net Interest Income                                 | 10,459                         | 11,682   |
| Provision for Loan Losses                           | -                              | 294      |
| Net Interest Income After Provision for Loan Losses | 10,459                         | 11,388   |
| Noninterest Income:                                 |                                |          |
| Trust fees  | 1,122                          | 588      |
| Service charges on deposit accounts                 | 413                            | 409      |
| Other fees and commissions                          | 444                            | 459      |
| Mortgage banking income                             | 263                            | 718      |
| Securities gains, net                               | 39                             | 198      |
| Other   | 422                            | 398      |
| Total noninterest income                            | 2,703                          | 2,770    |
| Noninterest Expense:                                |                                |          |
| Salaries  | 3,538                          | 3,439    |
| Employee benefits                                   | 975                            | 899      |
| Occupancy and equipment                             | 936                            | 916      |
| FDIC assessment                                     | 164                            | 161      |
| Bank franchise tax                                  | 222                            | 187      |
| Core deposit intangible amortization                | 331                            | 420      |
| Data processing                                     | 348                            | 277      |
| Software  | 262                            | 212      |
| Foreclosed real estate, net                         | 16                             | 243      |

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|                            |         |         |
|----------------------------|---------|---------|
| Other                      | 1,631   | 1,564   |
| Total noninterest expense  | 8,423   | 8,318   |
| Income Before Income Taxes | 4,739   | 5,840   |
| Income Taxes               | 1,289   | 1,689   |
| Net Income                 | \$3,450 | \$4,151 |

Net Income Per Common Share:

|                                    |           |           |
|------------------------------------|-----------|-----------|
| Basic                              | \$0.44    | \$0.53    |
| Diluted                            | \$0.44    | \$0.53    |
| Average Common Shares Outstanding: |           |           |
| Basic                              | 7,904,759 | 7,861,991 |
| Diluted                            | 7,917,601 | 7,871,508 |

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



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American National Bankshares Inc. and Subsidiaries  
 Consolidated Statements of Comprehensive Income  
 (Dollars in thousands) (Unaudited)

|  | Three Months<br>Ended<br>March 31 |         |
|--|-----------------------------------|---------|
|  | 2014                              | 2013    |
| Net income   | \$3,450                           | \$4,151 |
| Other comprehensive income (loss):                         |                                   |         |
| Unrealized gains (losses) on securities available for sale | 1,809                             | (882 )  |
| Income tax (expense) benefit                               | (633 )                            | 309     |
| Reclassification adjustment for gains on securities        | (39 )                             | (198 )  |
| Income tax expense   | 14                                | 69      |
| Other comprehensive income (loss)                          | 1,151                             | (702 )  |
| Comprehensive income                                       | \$4,601                           | \$3,449 |

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

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American National Bankshares Inc. and Subsidiaries  
 Consolidated Statements of Changes in Shareholders' Equity  
 Three Months Ended March 31, 2014 and 2013  
 (Dollars in thousands except per share data) (Unaudited)

|   | Common<br>Stock | Capital<br>in<br>Excess<br>of<br>Par<br>Value | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Shareholders'<br>Equity |
|---|-----------------|---|----------------------|---|----------------------------------|
| Balance, December 31, 2012                | \$ 7,847        | \$57,211                                      | \$90,591             | \$ 7,597  | \$ 163,246                       |
| Net income                                | -               | -   | 4,151                | -   | 4,151                            |
| Other comprehensive loss                  | -               | -   | -                    | (702 )  | (702 )                           |
| Equity based compensation                 | 16              | 130   | -                    | -   | 146                              |
| Cash dividends declared, \$0.23 per share | -               | -   | (1,809 )             | -   | (1,809 )                         |
| Balance, March 31, 2013                   | \$ 7,863        | \$57,341                                      | \$92,933             | \$ 6,895  | \$ 165,032                       |
| Balance, December 31, 2013                | \$ 7,891        | \$58,050                                      | \$99,090             | \$ 2,520  | \$ 167,551                       |
| Net income                                | -               | -   | 3,450                | -   | 3,450                            |
| Other comprehensive income                | -               | -   | -                    | 1,151   | 1,151                            |
| Equity based compensation                 | 14              | 152   | -                    | -   | 166                              |
| Cash dividends declared, \$0.23 per share | -               | -   | (1,819 )             | -   | (1,819 )                         |
| Balance, March 31, 2014                   | \$ 7,905        | \$58,202                                      | \$100,721            | \$ 3,671  | \$ 170,499                       |

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

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American National Bankshares Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Three Months Ended March 31, 2014 and 2013  
(Dollars in thousands) (Unaudited)

|   | 2014      |  | 2013      |
|---|-----------|--|-----------|
| Cash Flows from Operating Activities:   |           |  |           |
| Net income  | \$ 3,450  |  | \$ 4,151  |
| Adjustments to reconcile net income to net cash provided by operating activities: |           |  |           |
| Provision for loan losses   | -         |  | 294       |
| Depreciation  | 434       |  | 424       |
| Net accretion of purchase accounting adjustments                                  | (896 )    |  | (1,983 )  |
| Core deposit intangible amortization  | 331       |  | 420       |
| Net amortization (accretion) of securities  | 668       |  | 788       |
| Net gain on sale or call of securities  | (39 )     |  | (198 )    |
| Gain on sale of loans held for sale   | (215 )    |  | (650 )    |
| Proceeds from sales of loans held for sale  | 13,745    |  | 33,782    |
| Originations of loans held for sale   | (12,159 ) |  | (23,675 ) |
| Net gain on foreclosed real estate  | (49 )     |  | (14 )     |
| Valuation allowance on foreclosed real estate                                     | 24        |  | 70        |
| Equity based compensation expense   | 166       |  | 146       |
| Deferred income tax expense (benefit)   | 94        |  | (43 )     |
| Net change in interest receivable   | 344       |  | 175       |
|   | (565 )    |  | (1,504 )  |

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|   |           |           |
|---|-----------|-----------|
| Net change in other assets  |           |           |
| Net change in interest payable  | (43 )     | (23 )     |
| Net change in other liabilities   | 1,143     | 1,813     |
| Net cash provided by operating activities                                     | 6,433     | 13,973    |
| Cash Flows from Investing Activities:   |           |           |
| Proceeds from sales of securities available for sale                          | 2,061     | 2,627     |
| Proceeds from maturities, calls and paydowns of securities available for sale | 22,540    | 9,329     |
| Purchases of securities available for sale                                    | (26,459 ) | (19,555 ) |
| Net change in restricted stock  | 360       | 411       |
| Net decrease (increase) in loans  | 12,225    | (2,112 )  |
| Purchases of premises and equipment   | (119 )    | (178 )    |
| Proceeds from sales of foreclosed real estate                                 | 232       | 645       |
| Net cash provided by (used in) investing activities                           | 10,840    | (8,833 )  |
| Cash Flows from Financing Activities:   |           |           |
| Net change in demand, money market, and savings deposits                      | 5,164     | 4,199     |
| Net change in time deposits   | (11,590 ) | 5,986     |
| Net change in customer repurchase agreements                                  | (5,325 )  | (3,276 )  |
| Net change in long-term borrowings  | (38 )     | (37 )     |
| Common stock dividends paid   | (1,819 )  | (1,809 )  |
|   | (13,608 ) | 5,063     |

Net cash (used in)  
provided by financing  
activities

|  |       |        |
|--|-------|--------|
| Net Increase in Cash<br>and Cash Equivalents | 3,665 | 10,203 |
|--|-------|--------|

|  |        |        |
|--|--------|--------|
| Cash and Cash<br>Equivalents at<br>Beginning of Period | 67,681 | 47,442 |
|--|--------|--------|

|  |           |           |
|--|-----------|-----------|
| Cash and Cash<br>Equivalents at End of<br>Period | \$ 71,346 | \$ 57,645 |
|--|-----------|-----------|

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

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

Note 1 – Basis of Presentation

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

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of foreclosed real estate, goodwill and intangible assets, the valuation of deferred tax assets, other-than-temporary impairments of securities, and acquired loans with specific credit-related deterioration.

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

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the results of the interim periods. The results of operations for the interim periods are not necessarily indicative of the results that may occur for the year ending December 31, 2014. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Note 2 – Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2014-01, "Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-01 to have a material impact on its consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, "Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU clarify that an in substance

repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements.

In April 2014, the FASB issued ASU 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." The amendments in this ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results and include disposals of a major geographic area, a major line of business, or a major equity method investment. The new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. Additionally, the new guidance requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in the ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-08 to have a material impact on its consolidated financial statements.

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## Note 3 – Securities

The amortized cost and estimated fair value of investments in debt and equity securities at March 31, 2014 and December 31, 2013 were as follows:

| (in thousands)                      | March 31, 2014 |                  |                   | Estimated  |
|-------------------------------------|----------------|------------------|-------------------|------------|
|                                     | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Securities available for sale:      |                |                  |                   |            |
| Federal agencies and GSEs           | \$72,872       | \$ 107           | \$ 394            | \$72,585   |
| Mortgage-backed and CMOs            | 64,129         | 940              | 398               | 64,671     |
| State and municipal                 | 194,114        | 7,178            | 287               | 201,005    |
| Corporate                           | 9,733          | 13               | 115               | 9,631      |
| Equity securities                   | 1,000          | 231              | -                 | 1,231      |
| Total securities available for sale | \$341,848      | \$ 8,469         | \$ 1,194          | \$349,123  |

| (in thousands)                      | December 31, 2013 |                  |                   | Estimated  |
|-------------------------------------|-------------------|------------------|-------------------|------------|
|                                     | Amortized Cost    | Unrealized Gains | Unrealized Losses | Fair Value |
| Securities available for sale:      |                   |                  |                   |            |
| Federal agencies and GSE            | \$66,241          | \$ 126           | \$ 486            | \$65,881   |
| Mortgage-backed and CMOs            | 69,168            | 1,085            | 645               | 69,608     |
| State and municipal                 | 193,251           | 5,999            | 517               | 198,733    |
| Corporate                           | 10,959            | 4                | 164               | 10,799     |
| Equity securities                   | 1,000             | 103              | -                 | 1,103      |
| Total securities available for sale | \$340,619         | \$ 7,317         | \$ 1,812          | \$346,124  |

## Restricted Stock

Due to restrictions placed upon the Bank's common stock investment in the Federal Reserve Bank of Richmond ("FRB") and Federal Home Loan Bank of Atlanta ("FHLB"), these securities have been classified as restricted equity securities and carried at cost. The restricted securities are not subject to the investment security classification and are included as a separate line item on the Company's balance sheet. The Federal Reserve Bank of Richmond requires the Bank to maintain stock with a par value equal to 4.5% of its outstanding capital. The FHLB requires the Bank to maintain stock in an amount equal to 6% of outstanding borrowings and a specific percentage of the Bank's total assets. The Bank also owns common stock in CBB Financial Corporation, a Community Bankers Bank located in Richmond, Virginia which provides services to community banks that was inherited from the merger with Community First Financial Corporation in 2006 and common stock in Danville Community Development Corporation, a corporation formed by local banks in the Danville, Virginia area that restores dilapidated properties for resale. The cost of restricted stock at March 31, 2014 and December 31, 2013 were as follows:

| (in thousands)                                   | March 31, 2014 | December 31, 2013 |
|--|----------------|-------------------|
| FRB stock  | \$2,727        | \$ 2,722          |
| FHLB stock                                       | 1,635          | 2,000             |
| CBB Financial Corporation stock                  | 101            | 101               |
| Danville Community Development Corporation stock | 66             | 66                |



Total restricted stock \$4,529 \$ 4,889

#### Temporarily Impaired Securities

The following table shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2014. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period.

| (in thousands)            | Total      |                 | Less than 12 Months |                 | 12 Months or More |                 |
|---------------------------|------------|-----------------|---------------------|-----------------|-------------------|-----------------|
|                           | Estimated  |                 | Estimated           |                 | Estimated         |                 |
|                           | Fair Value | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss |
| Federal agencies and GSEs | \$52,841   | \$ 394          | \$52,841            | \$ 394          | \$-               | \$ -            |
| Mortgage-backed and CMOs  | 21,655     | 398             | 19,001              | 354             | 2,654             | 44              |
| State and municipal       | 25,232     | 287             | 20,672              | 215             | 4,560             | 72              |
| Corporate                 | 6,212      | 115             | 6,212               | 115             | -                 | -               |
| Total                     | \$105,940  | \$ 1,194        | \$98,726            | \$ 1,078        | \$7,214           | \$ 116          |

GSE debt securities: The unrealized losses on the Company's investment in 26 government sponsored entities ("GSE") were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at March 31, 2014.

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Mortgage-backed securities and CMOs: The unrealized losses on the Company's investment in 16 GSE mortgage-backed securities and collateralized mortgage obligations ("CMOs") were caused by interest rate increases. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at March 31, 2014.

State and municipal securities: The unrealized losses on 28 state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at March 31, 2014.

Corporate securities: The unrealized losses on six investments in corporate securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at March 31, 2014.

Restricted stock: When evaluating restricted stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The company does not consider restricted stock to be other-than-temporarily impaired at March 31, 2014, and no impairment has been recognized.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position, at December 31, 2013.

| (in thousands)            | Total      |                 | Less than 12 Months |                 | 12 Months or More |                 |
|---------------------------|------------|-----------------|---------------------|-----------------|-------------------|-----------------|
|                           | Estimated  |                 | Estimated           |                 | Estimated         |                 |
|                           | Fair Value | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss |
| Federal agencies and GSEs | \$41,586   | \$ 486          | \$41,586            | \$ 486          | \$-               | \$ -            |
| Mortgage-backed and CMOs  | 23,916     | 645             | 19,042              | 577             | 4,874             | 68              |
| State and municipal       | 33,192     | 517             | 29,732              | 462             | 3,460             | 55              |
| Corporate                 | 7,347      | 164             | 7,347               | 164             | -                 | -               |
| Total                     | \$106,041  | \$ 1,812        | \$97,707            | \$ 1,689        | \$8,334           | \$ 123          |

## Other-Than-Temporary-Impaired Securities

As of March 31, 2014 and December 31, 2013, there were securities classified as having other-than-temporary impairment.

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## Note 4 - Loans

Segments

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

| (in thousands)                    | March<br>31, 2014 | December<br>31, 2013 |
|-----------------------------------|-------------------|----------------------|
| Commercial                        | \$ 119,042        | \$ 122,553           |
| Commercial real estate:           |                   |                      |
| Construction and land development | 40,458            | 41,822               |
| Commercial real estate            | 358,362           | 364,616              |
| Residential real estate:          |                   |                      |
| Residential                       | 170,517           | 171,917              |
| Home equity                       | 89,081            | 87,797               |
| Consumer                          | 5,909             | 5,966                |
| Total loans                       | \$ 783,369        | \$ 794,671           |

Acquired Loans

Interest income, including accretion, on loans acquired from MidCarolina Financial Corporation ("MidCarolina") in connection with the Company's acquisition of MidCarolina for the three months ended March 31, 2014 was approximately \$3.4 million. This included \$1.1 million in accretion income of which \$88,000 was related to loan payoffs and renewals and \$410,000 related to recoveries of loans charged off prior to the merger. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheets at March 31, 2014 and December 31, 2013 are as follows:

| (in thousands)                | March<br>31, 2014 | December<br>31, 2013 |
|-------------------------------|-------------------|----------------------|
| Outstanding principal balance | \$ 110,702        | \$ 134,099           |
| Carrying amount               | 102,133           | 124,828              |

The outstanding principal balance and related carrying amount of acquired impaired loans, for which the Company applies Accounting Standards Codification ("ASC") 310-30 (formerly Statement of Position ("SOP") 03-3), to account for interest earned, at March 31, 2014 and December 31, 2013 are as follows:

| (in thousands)                | March<br>31,<br>2014 | December<br>31, 2013 |
|-------------------------------|----------------------|----------------------|
| Outstanding principal balance | \$ 19,958            | \$ 21,014            |
| Carrying amount               | 15,909               | 16,644               |

The following table presents changes in the accretable discount on acquired impaired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), for the three months ended March 31, 2014. The accretion reflected below includes \$88,000 related to loan payoffs.

| (in thousands) | Accretable<br>Discount |
|----------------|------------------------|
|----------------|------------------------|

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|  |          |
|--|----------|
| Balance at December 31, 2013                   | \$ 2,046 |
| Accretion                                      | (440 )   |
| Reclassification from nonaccretable difference | 236      |
| Balance at March 31, 2014                      | \$ 1,842 |

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IndexPast Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at March 31, 2014.

| (in thousands)                    | 30-                       | 60-89               | 90 Days                                | Non-<br>Accrual<br>Loans | Total<br>Past<br>Due | Current    | Total<br>Loans |
|-----------------------------------|---------------------------|---------------------|--|--------------------------|----------------------|------------|----------------|
|                                   | 59<br>Days<br>Past<br>Due | Days<br>Past<br>Due | +<br>Past Due<br>and Still<br>Accruing |                          |                      |            |                |
| Commercial                        | \$ 69                     | \$ -                | \$ -                                   | \$ 9                     | \$ 78                | \$ 118,964 | \$ 119,042     |
| Commercial real estate:           |                           |                     |  |                          |                      |            |                |
| Construction and land development | -                         | -                   | -                                      | 909                      | 909                  | 39,549     | 40,458         |
| Commercial real estate            | -                         | 312                 | -                                      | 3,296                    | 3,608                | 354,754    | 358,362        |
| Residential:                      |                           |                     |  |                          |                      |            |                |
| Residential                       | 201                       | 147                 | -                                      | 931                      | 1,279                | 169,238    | 170,517        |
| Home equity                       | 109                       | 432                 | -                                      | 409                      | 950                  | 88,131     | 89,081         |
| Consumer                          | 3                         | -                   | -                                      | 3                        | 6                    | 5,903      | 5,909          |
| Total                             | \$ 382                    | \$ 891              | \$ -                                   | \$ 5,557                 | \$ 6,830             | \$ 776,539 | \$ 783,369     |

The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2013.

| (in thousands)                    | 30- 59              | 60-89               | 90 Days                                | Non-<br>Accrual<br>Loans | Total<br>Past<br>Due | Current    | Total<br>Loans |
|-----------------------------------|---------------------|---------------------|--|--------------------------|----------------------|------------|----------------|
|                                   | Days<br>Past<br>Due | Days<br>Past<br>Due | +<br>Past Due<br>and Still<br>Accruing |                          |                      |            |                |
| Commercial                        | \$ 27               | \$ -                | \$ -                                   | \$ 11                    | \$ 38                | \$ 122,515 | \$ 122,553     |
| Commercial real estate:           |                     |                     |  |                          |                      |            |                |
| Construction and land development | -                   | 51                  | -                                      | 877                      | 928                  | 40,894     | 41,822         |
| Commercial real estate            | 667                 | -                   | -                                      | 2,879                    | 3,546                | 361,070    | 364,616        |
| Residential:                      |                     |                     |  |                          |                      |            |                |
| Residential                       | 642                 | 202                 | -                                      | 880                      | 1,724                | 170,193    | 171,917        |
| Home equity                       | 109                 | 18                  | -                                      | 424                      | 551                  | 87,246     | 87,797         |
| Consumer                          | 21                  | 1                   | -                                      | -                        | 22                   | 5,944      | 5,966          |
| Total                             | \$ 1,466            | \$ 272              | \$ -                                   | \$ 5,071                 | \$ 6,809             | \$ 787,862 | \$ 794,671     |

IndexImpaired Loans

The following table presents the Company's impaired loan balances by portfolio segment, excluding loans acquired with deteriorated credit quality, at March 31, 2014.

| (in thousands)                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 16                  | \$ 16                          | \$ -                 | \$ 14                             | \$ -                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 63                     | 63                             | -                    | 64                                | -                                |
| Commercial real estate              | 1,942                  | 1,955                          | -                    | 2,063                             | 1                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 932                    | 936                            | -                    | 956                               | -                                |
| Home equity                         | 409                    | 409                            | -                    | 413                               | -                                |
| Consumer                            | 3                      | 3                              | -                    | 3                                 | -                                |
|                                     | \$ 3,365               | \$ 3,382                       | \$ -                 | \$ 3,513                          | \$ 1                             |
| With a related allowance recorded:  |                        |                                |                      |                                   |                                  |
| Commercial                          | -                      | -                              | -                    | -                                 | -                                |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 1,453                  | 1,496                          | 88                   | 1,456                             | 8                                |
| Commercial real estate              | 2,231                  | 2,239                          | 483                  | 2,246                             | 2                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 4                      | -                              | -                    | -                                 | -                                |
| Home equity                         | -                      | -                              | -                    | -                                 | -                                |
| Consumer                            | 17                     | 17                             | 3                    | 18                                | -                                |
|                                     | \$ 3,705               | \$ 3,752                       | \$ 574               | \$ 3,720                          | \$ 10                            |
| Total:                              |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 16                  | \$ 16                          | \$ -                 | \$ 14                             | \$ -                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 1,516                  | 1,559                          | 88                   | 1,520                             | 8                                |
| Commercial real estate              | 4,173                  | 4,194                          | 483                  | 4,309                             | 3                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 936                    | 936                            | -                    | 956                               | -                                |
| Home equity                         | 409                    | 409                            | -                    | 413                               | -                                |
| Consumer                            | 20                     | 20                             | 3                    | 21                                | -                                |
|                                     | \$ 7,070               | \$ 7,134                       | \$ 574               | \$ 7,233                          | \$ 11                            |

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The following table presents the Company's impaired loan balances by portfolio segment, excluding loans acquired with deteriorated credit quality, at December 31, 2013.

| (in thousands)                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 19                  | \$ 19                          | \$ -                 | \$ 20                             | \$ 1                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 18                     | 18                             | -                    | 261                               | 4                                |
| Commercial real estate              | 936                    | 936                            | -                    | 950                               | 13                               |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 880                    | 888                            | -                    | 1,200                             | 11                               |
| Home equity                         | 424                    | 424                            | -                    | 433                               | -                                |
| Consumer                            | -                      | -                              | -                    | -                                 | -                                |
|                                     | \$ 2,277               | \$ 2,285                       | \$ -                 | \$ 2,864                          | \$ 29                            |
| With a related allowance recorded:  |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ -                   | \$ -                           | \$ -                 | \$ -                              | \$ -                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 1,468                  | 1,507                          | 68                   | 1,551                             | 33                               |
| Commercial real estate              | 2,266                  | 2,264                          | 488                  | 1,198                             | 7                                |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 1,198                  | -                              | -                    | -                                 | -                                |
| Home equity                         | -                      | -                              | -                    | -                                 | -                                |
| Consumer                            | 18                     | 18                             | 3                    | 19                                | 1                                |
|                                     | \$ 3,752               | \$ 3,789                       | \$ 559               | \$ 2,768                          | \$ 41                            |
| Total:                              |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 19                  | \$ 19                          | \$ -                 | \$ 20                             | \$ 1                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 1,486                  | 1,525                          | 68                   | 1,812                             | 37                               |
| Commercial real estate              | 3,202                  | 3,200                          | 488                  | 2,148                             | 20                               |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 880                    | 888                            | -                    | 1,200                             | 11                               |
| Home equity                         | 424                    | 424                            | -                    | 433                               | -                                |
| Consumer                            | 18                     | 18                             | 3                    | 19                                | 1                                |
|                                     | \$ 6,029               | \$ 6,074                       | \$ 559               | \$ 5,632                          | \$ 70                            |

There were no loans modified as a troubled debt restructuring ("TDR") for the three months ended March 31, 2014 and 2013.

None of the loans modified as a TDR within the previous twelve months have subsequently defaulted during the three month periods ending March 31, 2014 and 2013.

IndexRisk Grades

The following table shows the Company's loan portfolio broken down by internal risk grading as of March 31, 2014.

(in thousands)

Commercial and Consumer Credit Exposure

Credit Risk Profile by Internally Assigned Grade

|                 | Commercial | Commercial<br>Real Estate<br>Construction | Commercial<br>Real Estate<br>Other | Residential | Home<br>Equity |
|-----------------|------------|---|------------------------------------|-------------|----------------|
| Pass            | \$ 117,576 | \$ 33,911                                 | \$ 347,780                         | \$ 158,722  | \$ 86,519      |
| Special Mention | 1,450      | 887                                       | 5,345                              | 8,265       | 1,788          |
| Substandard     | 16         | 5,660                                     | 5,237                              | 3,530       | 774            |
| Doubtful        | -          | -   | -                                  | -           | -              |
| Total           | \$ 119,042 | \$ 40,458                                 | \$ 358,362                         | \$ 170,517  | \$ 89,081      |

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

Consumer

|               |          |
|---------------|----------|
| Performing    | \$ 5,906 |
| Nonperforming | 3        |
| Total         | \$ 5,909 |

The following table shows the Company's loan portfolio broken down by internal risk grading as of December 31, 2013.

(in thousands)

Commercial and Consumer Credit Exposure

Credit Risk Profile by Internally Assigned Grade

|                 | Commercial | Commercial<br>Real Estate<br>Construction | Commercial<br>Real Estate<br>Other | Residential | Home<br>Equity |
|-----------------|------------|---|------------------------------------|-------------|----------------|
| Pass            | \$ 121,033 | \$ 35,563                                 | \$ 351,801                         | \$ 158,478  | \$ 85,163      |
| Special Mention | 1,500      | 1,005                                     | 6,795                              | 8,242       | 1,650          |
| Substandard     | 20         | 5,254                                     | 6,020                              | 5,197       | 984            |
| Doubtful        | -          | -   | -                                  | -           | -              |
| Total           | \$ 122,553 | \$ 41,822                                 | \$ 364,616                         | \$ 171,917  | \$ 87,797      |

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

Consumer

|            |          |
|------------|----------|
| Performing | \$ 5,966 |
|------------|----------|



|               |          |
|---------------|----------|
| Nonperforming | -        |
| Total         | \$ 5,966 |

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

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

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

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

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

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

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

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

| (in thousands)               | Three<br>Months<br>Ended<br>March<br>31,<br>2014 | Year<br>Ended<br>December<br>31, 2013 | Three<br>Months<br>Ended<br>March<br>31,<br>2013 |
|------------------------------|--|---------------------------------------|--|
| Allowance for Loan Losses    |  |                                       |  |
| Balance, beginning of period | \$12,600   | \$ 12,118                             | \$12,118   |
| Provision for loan losses    | -  | 294                                   | 294  |
| Charge-offs                  | (73 )  | (837 )                                | (287 )   |
| Recoveries                   | 87   | 1,025                                 | 403  |
| Balance, end of period       | \$12,614   | \$ 12,600                             | \$12,528   |

| Reserve for Unfunded Lending Commitments |       |        |       |
|--|-------|--------|-------|
| Balance, beginning of period             | \$210 | \$ 201 | \$201 |
| Provision for loan losses                | 7     | 9      | 10    |
| Charge-offs                              | -     | -      | -     |
| Balance, end of period                   | \$217 | \$ 210 | \$211 |

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at March 31, 2014.

| (in thousands)                  | Commercial | Commercial<br>Real Estate | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------------|------------|---------------------------|----------------------------|----------|-------------|----------|
| Allowance for Loan Losses       |            |                           |                            |          |             |          |
| Balance as of December 31, 2013 | \$ 1,810   | \$ 6,819                  | \$ 3,690                   | \$ 99    | \$ 182      | \$12,600 |
| Charge-offs                     | -          | -                         | (53 )                      | (20 )    | -           | (73 )    |
| Recoveries                      | 8          | 14                        | 43                         |          |             |          |