AMERICAN NATIONAL BANKSHARES INC
Form 10-K
March 15, 2007

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

FORM 10-K

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

For the fiscal year ended December 31, 2006
or

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

For the transition period from______________________ to ___________________

Commission file number 0-12820

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

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

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

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

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to section 12(g) of the Act:

Common Stock, $1 Par Value
(Title of class)

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant at June 30, 2006, based on the closing price, was $122,712,815.

The number of shares of the Registrant's Common Stock outstanding on March 7, 2007 was 6,160,223.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held on April 24, 2007 are incorporated by reference in Part III of this report.

CROSS REFERENCE INDEX

---

*The information required by Item 10 is incorporated herein by reference to the information that appears under the headings "Election of Directors - Board of Directors and Committees—The Audit and Compliance Committee," "Section 16(a) Beneficial Ownership Reporting Compliance," "Report of the Audit and Compliance Committee," and "Code of Conduct" in the Registrant's Proxy Statement for the 2007 Annual Meeting of Shareholders.

The information required by Item 11 is incorporated herein by reference to the information that appears under the heading "Compensation Discussion and Analysis," "Compensation Committee Interlocks and Insider Participation," and "Compensation Committee Report" in the Registrant's Proxy Statement for the 2007 Annual Meeting of Shareholders.

Index

The information required by Item 12 is incorporated herein by reference to the information that appears under the headings "Security Ownership" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Registrant's Proxy Statement for the 2007 Annual Meeting of Shareholders. The information required by Item 201(d) of Regulation S-K is disclosed herein. See Item 5, "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities."

The information required by Item 13 is incorporated herein by reference to the information that appears under the heading "Related Party Transactions," and "Election of Directors - Board Independence" in the Registrant's Proxy Statement for the 2007 Annual Meeting of Shareholders.

The information required by Item 14 is incorporated herein by reference to the information that appears under the heading "Independent Public Accountants" in the Registrant's Proxy Statement for the 2007 Annual Meeting of Shareholders.

PART I
FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements with respect to the financial condition, results of operations and business of American National Bankshares Inc. and its wholly owned subsidiary, American National Bank and Trust Company (collectively referred to as the "Company"). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on information available to management at the time these statements and disclosures were prepared. Factors that may cause actual results to differ materially from those expected include the following:

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

ITEM 1 - BUSINESS

The Company is a one-bank holding company organized under the laws of the Commonwealth of Virginia in 1984. On September 1, 1984, American National Bankshares Inc. acquired all of the outstanding capital stock of American National Bank and Trust Company, a national banking association chartered in 1909 under the laws of the United States. American National Bank and Trust Company is the only banking subsidiary of American National Bankshares Inc. In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the "Trust") and a wholly owned subsidiary of American National Bankshares Inc. was formed for the purpose of issuing preferred securities (the "Trust Preferred Securities") in a private placement pursuant to an applicable exemption from registration. Proceeds from the securities were used to fund the acquisition of Community First Financial Corporation ("Community First"). In April 2006, the Company finalized the acquisition of Community First and acquired 100% of the preferred and common stock. Community First was a bank holding company headquartered in Lynchburg, Virginia, and through its subsidiary, Community First Bank, operated four banking offices serving the city of Lynchburg and Bedford, Nelson and Amherst Counties. The reported annual results of operations as of December 31, 2006 for the Company include Community First since the date of acquisition. The Company entered into the merger agreement with Community First because it believed the merger to be consistent with its expansion strategy to target entry into strong markets that logically extend its existing footprint. The Company had previously opened a full service banking office in the Lynchburg area and was considering opening additional offices in that area.

The operations of the Company are conducted at eighteen retail offices. These offices serve Danville, Pittsylvania County, Martinsville, Henry County, South Boston, Halifax County, Lynchburg, Bedford, Bedford County, Campbell County, and portions of Nelson County in Virginia, along with portions of Caswell County in North Carolina. The Company also operates a loan production office in Greensboro, North Carolina. American National Bank and Trust Company provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through twenty-three ATMs, “AmeriLink” Internet banking, and 24-hour “Access American” telephone banking.

Competition and Markets

Vigorous competition exists in the Company's service area. The Company competes not only with other commercial banks but also with diversified financial institutions, credit unions, money market and mutual fund providers, mortgage lenders, insurance companies, and finance companies. The Company has the largest deposit market share in the City of Danville.

The Southside Virginia market, in which the Company has a significant presence, is under economic pressure. The region's economic base has historically been weighted toward the manufacturing sector. Increased global competition has negatively impacted the textile industry and several manufacturers have closed plants due to competitive pressures or the relocation of some operations to foreign countries. Other important industries include farming, tobacco processing and sales, food processing, furniture manufacturing and sales, specialty glass manufacturing, and packaging tape production. Unemployment as a percent of the workforce remains greater than that of other regions of Virginia. Additional declines in manufacturing production and unemployment could negatively impact the ability of certain borrowers to repay loans and certain depositors to maintain account balances. To mitigate this risk and to establish a platform for higher growth, the Company opened a loan production office in Greensboro, North Carolina during 2004, and a full service office in Bedford County, Virginia, serving the Lynchburg area, during 2005. The Company continued the expansion into the Lynchburg area by acquiring Community First Financial Corporation in April 2006.

Supervision and Regulation

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

American National Bankshares Inc.

American National Bankshares Inc. is qualified as a bank holding company ("BHC") within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), and is registered as such with the Board of Governors of the Federal Reserve System (the "FRB"). The BHC Act permits a financial holding company to engage in a variety of financial activities, some of which are not permitted for other bank holding companies that are not financial holding companies. As a bank holding company, American National Bankshares Inc. is required to file various reports and additional information with the FRB and is also subject to examinations by the FRB.

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

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

Under the Gramm-Leach-Bliley Act, a BHC may elect to become a financial holding company and thereby engage in a broader range of financial and other activities than are permissible for traditional BHC's. In order to qualify for the election, all of the depository institution subsidiaries of the BHC must be well capitalized, well managed, and have achieved a rating of "satisfactory" or better under the Community Reinvestment Act (the "CRA"). Financial holding companies are permitted to engage in activities that are "financial in nature" or incidental or complementary thereto as determined by the FRB. The Gramm-Leach-Bliley Act identifies several activities as "financial in nature," including insurance underwriting and sales, investment advisory services, merchant banking and underwriting, and dealing or making a market in securities. American National Bankshares Inc. has not elected to become a financial holding company.

Index

American National Bank and Trust Company

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

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

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

Dividend Restrictions and Capital Requirements

For information regarding the limitation on bank dividends and risk-based capital requirements, refer to Note 19 of the consolidated financial statements. Additional information may be found in the Shareholder’s Equity section of Management’s Discussion and Analysis of Financial Condition and Results of Operations.

FDIC Insurance

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

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

The Federal Deposit Insurance Corporation Improvement Act

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), the federal banking agencies possess broad powers to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution is “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” or “critically undercapitalized,” as defined by the law. Under regulations established by the federal banking agencies a “well capitalized” institution must have a Tier 1 capital ratio of at least 6%, a total capital ratio of at least 10%, and a leverage ratio of at least 5%, and not be subject to a capital directive order. An “adequately capitalized” institution must have a Tier 1 capital ratio of a least 4%, a total capital ratio of at least 8%, and a leverage ratio of at least 4%, or 3% in some cases. Management believes, as of December 31, 2006 and 2005, that the Company met the requirements for being classified as “well capitalized.”

As required by FDICIA, the federal banking agencies also have adopted guidelines prescribing safety and soundness standards relating to, among other things, internal controls and information systems, internal audit systems, loan documentation, credit underwriting, and interest rate exposure. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. In addition, the agencies adopted regulations that authorize, but do not require, an institution who has been notified that it is not in compliance with safety and soundness standard to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the prompt corrective action provisions described above.

Community Reinvestment and Consumer Protection Laws

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

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

Anti-Money Laundering Legislation

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

Employees

At December 31, 2006, the Company employed 253 full-time equivalent persons. The relationship with employees is considered to be good.

Internet Access to Company Documents

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

ITEM 1A - RISK FACTORS

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

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

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

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

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

Changes in economic conditions, particularly an economic slowdown in the Company's market area, could materially and negatively affect the Company's business.

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

Trust and Investment Services fee revenue is largely dependent on the fair market value of assets under care and on trading volumes in the brokerage business. General economic conditions and their subsequent effect on the securities markets tend to act in correlation. When general economic conditions deteriorate, consumer and corporate confidence in securities markets erodes, and Trust and Investment Service revenues are negatively impacted as asset values and trading volumes decrease. Neutral economic conditions can also negatively impact revenue when stagnant securities markets fail to attract investors.

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

A downturn in the real estate market could negatively affect the Company's business because significant portions (approximately 81% as of December 31, 2006) of its loans are secured by real estate. The ability to recover on defaulted loans by selling the real estate collateral would then be diminished and the Company would be more likely to suffer losses on defaulted loans.

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

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

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

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

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

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

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

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

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

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

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

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

The Company is exposed to operational risk.

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

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

Index

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

ITEM 2 - PROPERTIES

As of December 31, 2006, the Company maintained eighteen full service offices located in Danville, Pittsylvania County, Martinsville, Henry County, Halifax County, Lynchburg, Campbell County, and Nelson County in Virginia and Caswell County in North Carolina. The Company also operates a loan production office in Greensboro, North Carolina.

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

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

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

The Company owns eleven other retail office locations for a total of fourteen owned buildings. There are no mortgages or liens against any of the properties owned by the Company. The Company operates twenty-three Automated Teller Machines ("ATMs") on owned or leased facilities. The Company leases six of the retail office locations and a storage warehouse in Danville. One retail office location in Lynchburg is currently unoccupied.

There were no directors or executive officers with any ownership interest in any leased facility of the Company.

ITEM 3 - LEGAL PROCEEDINGS

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

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

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

Index

EXECUTIVE OFFICERS OF THE REGISTRANT

The following lists, as of December 31, 2006, the named executive officers of the registrant, their ages, and their positions.

Name	Age	Position
Charles H. Majors	61	President and Chief Executive Officer of the Company.
R. Helm Dobbins	55	Senior Vice President of American National Bankshares Inc.; Executive Vice President and Chief Credit Officer of American National Bank and Trust Company since November 2005; prior thereto, Senior Vice President and Chief Credit Officer of American National Bank and Trust Company since June 2003; Executive Vice President and Chief Credit Officer of Citizens Bank and Trust Co. from 1998 to 2003.
Jeffrey V. Haley	46	Senior Vice President of American National Bankshares Inc.; Executive Vice President and Chief Operating Officer of American National Bank and Trust Company since November 2005; prior thereto, Senior Vice President and Chief Administrative Officer of American National Bank and Trust Company.
Neal A. Petrovich	44	Senior Vice President, Chief Financial Officer, Treasurer and Secretary of American National Bankshares Inc.; Executive Vice President, Chief Financial Officer, and Cashier of American National Bank and Trust Company since November 2005; prior thereto, Senior Vice President, Chief Financial Officer and Cashier of American National Bank and Trust Company since May 2004; Senior Vice President of SouthTrust Bank from 2002 to May 2004; Executive Vice President and Chief Financial Officer of Bank of Tidewater from 1995 to 2002.

ITEM 5 - MARKET FOR RE ITEM 5 - ITEM 5 - MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common stock is traded on the NASDAQ Global Select Market under the symbol "AMNB." At December 31, 2006, the Company had 1,738 shareholders of record. The following table presents the high and low closing sales prices for the Company's common stock and dividends declared for the past two years.

Market Price of the Company's Common Stock

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

	Closing Price				Dividends Declared Per
2005		High		Low	Share
4th quarter	$	23.80	$	21.29	$ 0.21
3rd quarter		23.71		22.25	0.21
2nd quarter		25.04		22.28	0.21
1st quarter		24.84		23.85	0.20
					$ 0.83

The table below presents share repurchase activity during the quarter ended December 31, 2006.

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares That May Yet Be Purchased Under the Program
October 1-31, 2006	3,300	$ 23.56	3,300	121,700
November 1-30, 2006	-	-	-	121,700
December 1-31, 2006	1,600	23.55	1,600	120,100
	4,900	$ 23.56	4,900	

Stock Option Plan

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

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

Stock options became vested and exercisable in the manner specified by the committee. Each stock option or portion thereof shall be exercisable at any time on or after it vests and is exercisable until ten years after its date of grant. A review was performed of all stock option grants that verified all options were priced at the closing stock price on the day the option was approved by the Board of Directors and granted.

There were no stock options awarded in 2006. There are no plans at this time to make additional awards.

	December 31, 2006			
	Number of Shares to be Issued Upon Exercise of Outstanding Options		**Weighted-Average Per Share Exercise Price of Outstanding Options**	**Number of Shares Remaining Available for Future Issuance Under Stock Option Plan**
Equity compensation plans approved by shareholders	201,849	$	20.36	-
Equity compensation plans not approved by shareholders	-		-	-
Total	201,849	$	20.36	-

The Plan expired December 31, 2006; therefore, there are no shares remaining available for future issuance under the Plan at December 31, 2006.

Index

Comparative Stock Performance

The following graph compares the Company's cumulative total return to its shareholders with the returns of two indexes for the five-year period ended December 31, 2006. The cumulative total return was calculated taking into consideration changes in stock price, cash dividends, stock dividends, and stock splits since December 31, 2001. The two indexes are the NASDAQ Stock Index and the Carson Medlin Company's Independent Bank Index, consisting of 28 independent community banks located in Alabama, Florida, Georgia, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia.

	2001	2002	2003	2004	2005	2006
AMERICAN NATIONAL BANKSHARES, INC.	100	143	148	142	141	147
INDEPENDENT BANK INDEX	100	124	168	193	199	230
NASDAQ INDEX	100	69	103	113	115	126

Index
12

ITEM 6 - SELECTED FINANCIAL DATA

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

(in thousands, except per share amounts and ratios)	2006	2005	2004	2003	2002
Results of Operations:					
Interest income	$ 45,070	$ 32,479	$ 30,120	$ 32,178	$ 35,135
Interest expense	16,661	8,740	7,479	9,391	12,310
Net interest income	28,409	23,739	22,641	22,787	22,825
Provision for loan losses	58	465	3,095	920	873
Noninterest income	8,458	7,896	6,510	6,671	5,712
Noninterest expense	20,264	17,079	15,011	15,111	14,285
Income before income tax provision	16,545	14,091	11,045	13,427	13,379
Income tax provision	5,119	4,097	3,032	3,914	3,918
Net income	$ 11,426	$ 9,994	$ 8,013	$ 9,513	$ 9,461
Period-end Balances:					
Securities	$ 162,621	$ 165,629	$ 188,163	$ 207,479	$ 163,824
Loans, net of unearned income	542,228	417,087	407,269	406,245	406,403
Deposits	608,528	491,651	485,272	501,688	473,562
Shareholders' equity	94,992	73,419	71,000	71,931	70,736
Shareholders' equity - tangible (a)	69,695	73,287	70,516	70,997	69,352
Assets	777,720	623,503	619,065	644,302	605,859
Per Share Information:					
Earnings - basic	$ 1.91	$ 1.83	$ 1.43	$ 1.67	$ 1.63
Earnings - diluted	1.90	1.81	1.42	1.65	1.62
Dividends	0.87	0.83	0.79	0.75	0.71
Book value	15.42	13.49	12.86	12.71	12.24
Book value - tangible (a)	11.31	13.47	12.77	12.54	12.00
Ratios:					
Return on average assets	1.51%	1.61%	1.26%	1.52%	1.63%
Return on average shareholders' equity	12.72	13.95	11.15	13.52	13.97
Return on average tangible equity (b)	16.58	14.33	11.68	14.18	14.76
Net interest margin - taxable equivalent	4.20	4.17	3.90	3.98	4.28
Average shareholders' equity/average assets	11.85	11.57	11.34	11.27	11.64
Net charge-offs to average loans	0.10	0.56	0.10	0.30	0.15
Allowance for loan losses to period-end loans	1.34	1.46	1.96	1.30	1.38
	0.45	0.72	1.35	0.56	0.09

Nonperforming assets to total assets

(a) - Excludes goodwill and other intangible assets
(b) - Excludes amortization expense, net of tax, of intangible assets

Index
13

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

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

Reclassification

In certain circumstances, reclassifications have been made to prior period information to conform to the 2006 presentation.

Critical Accounting Policies

The Company's critical accounting policies are listed below. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements.

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

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

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

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

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

Goodwill and Other Intangible Assets

The Company adopted SFAS 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. Accordingly, goodwill is no longer subject to amortization over its estimated useful life, but is subject to at least an annual assessment for impairment by applying a fair value based test. The annual impairment analysis for goodwill and core deposit intangibles acquired with the acquisition of Community First is scheduled for the second quarter of 2007. Additionally, under SFAS 142, acquired intangible assets (such as core deposit intangibles) are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful lives. Branch acquisition transactions were outside the scope of SFAS 142 and, accordingly, intangible assets related to such transactions continued to amortize upon the adoption of SFAS 142. The cost of purchased deposit relationships and other intangible assets, based on an independent valuation by a qualified third party, are being amortized over their estimated lives. Amortization expense charged to operations was $414,000 and $353,000 for the twelve month periods ended December 31, 2006 and 2005, respectively.

Index

Non-GAAP Presentations

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

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

EXECUTIVE OVERVIEW

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

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

The Company specializes in providing financial services to businesses and consumers. Current priorities are to:
· increase the size of the loan portfolio without sacrificing credit quality or pricing,
· grow checking, savings and money market deposits,
· increase fee income, and
· continue to control costs.

ANALYSIS OF OPERATING RESULTS

The results of operations for the year ended December 31, 2006, include the affect of the acquisition of Community First Financial Corporation, which occurred April 1, 2006, and do not include the results of operations of Community First prior to April 1, 2006.

Net Interest Income

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

Net interest income on a tax-equivalent basis increased $4,556,000, or 18.4% from 2005 to 2006. The net interest margin, on a taxable equivalent basis, improved slightly from 4.17% to 4.20%.

The improvement in net interest income was due largely to the acquisition of Community First, which significantly increased the Company’s interest earning assets. The Bank’s highest yielding assets, loans, increased on average from $414,600,000 to $513,500,000, a 23.9% increase. Net interest income for 2006 also includes a positive impact of $313,000 related to the valuation of the loans acquired from Community First. Similarly, interest expense reflects a $153,000 reduction related to the valuation of certain Community First deposits. Beginning April 1, 2006, the loan valuation is being amortized over fifty-two months and the deposit valuation over thirteen months. Excluding these adjustments, the interest margin was 4.10% in 2006.

To meet its funding needs for the Community First acquisition, the Company issued $20,619,000 of trust preferred securities during the second quarter of 2006. Interest expense associated with these securities was $1,007,000 for 2006.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the years 2004 through 2006. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

Table 1 - Net Interest Income Analysis
(in thousands, except yields and rates)

	Average Balance			Interest Income/Expense			Average Yield/Rate		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
Loans:									
Commercial	$ 84,676	$ 74,202	$ 94,643	$ 6,481	$ 4,627	$ 4,992	7.65%	6.24%	5.27%
Real Estate	416,530	327,888	290,884	29,813	20,155	16,237	7.16	6.15	5.58
Consumer	12,287	12,490	18,168	1,152	1,132	1,664	9.38	9.06	9.16
Total loans	513,493	414,580	403,695	37,446	25,914	22,893	7.29	6.25	5.67
Securities:									
Federal agencies	94,589	77,609	99,263	3,745	2,414	3,169	3.96	3.11	3.19
Mortgage-backed	21,197	25,614	23,842	988	1,099	1,046	4.66	4.29	4.39
State and municipal	46,735	51,943	52,247	2,624	3,049	3,059	5.61	5.87	5.85
Other	11,059	15,273	19,776	621	715	923	5.62	4.68	4.67
Total securities	173,580	170,439	195,128	7,978	7,277	8,197	4.60	4.27	4.20
Deposits in other banks	12,922	9,782	10,092	620	376	132	4.80	3.84	1.31
Total interest earning assets	699,995	594,801	608,915	46,044	33,567	31,222	6.58	5.64	5.13
Nonearning assets	57,807	24,273	25,036						
Total assets	$ 757,802	$ 619,074	$ 633,951						
Deposits:									
Demand	$ 105,320	$ 82,121	$ 73,338	$ 1,513	$ 539	$ 269	1.44%	0.66%	0.37%
Money market	48,124	44,685	53,305	1,180	715	428	2.45	1.60	0.80
Savings	77,445	81,641	83,814	963	629	439	1.24	0.77	0.52
Time	255,856	189,467	204,945	9,693	5,019	4,843	3.79	2.65	2.36
Total deposits	486,745	397,914	415,402	13,349	6,902	5,979	2.74	1.73	1.44
Repurchase agreements	40,970	42,757	46,787	1,384	901	528	3.38	2.11	1.13
Other borrowings	33,087	19,474	20,931	1,928	937	972	5.83	4.81	4.64
Total interest bearing liabilities	560,802	460,145	483,120	16,661	8,740	7,479	2.97	1.90	1.55
Noninterest bearing demand deposits	102,117	84,670	76,123						
Other liabilities	5,059	2,621	2,846						
	89,824	71,638	71,862						

Shareholders' equity									
Total liabilities and shareholders' equity	$ 757,802	$ 619,074	$ 633,951						
Interest rate spread							3.61%	3.74%	3.58%
Net interest margin							4.20%	4.17%	3.90%
Net interest income (taxable equivalent basis)				29,383	24,827	23,743			
Less: Taxable equivalent adjustment				974	1,088	1,102			
Net interest income				$ 28,409	$ 23,739	$ 22,641			

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

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

	2006 vs. 2005			2005 vs. 2004		
	Interest Increase	Change Attributable to		Interest Increase	Change Attributable to	
Interest income	(Decrease)	Rate	Volume	(Decrease)	Rate	Volume
Loans:						
Commercial	$ 1,854	$ 1,144	$ 710	$ (365)	$ 820	$ (1,185)
Real Estate	9,658	3,652	6,006	3,918	1,736	2,182
Consumer	20	39	(19)	(532)	(17)	(515)
Total loans	11,532	4,835	6,697	3,021	2,539	482
Securities:						
Federal agencies	1,331	739	592	(755)	(80	(675)
Mortgage-backed	(111)	89	(200)	53	(23)	76
State and municipal	(425)	(129)	(296)	(10)	8	(18)
Other securities	(94)	126	(220)	(208)	3	(211)
Total securities	701	825	(124)	(920)	(92)	(828)
Deposits in other banks	244	106	138	244	248	(4)
Total interest income	12,477	5,766	6,711	2,345	2,695	(350)
Interest expense						
Deposits:						
Demand	974	787	187	270	234	36
Money market	465	406	59	287	366	(79)
Savings	334	368	(34)	190	202	(12)
Time	4,674	2,576	2,098	176	559	(383)
Total deposits	6,447	4,137	2,310	923	1,361	(438)
Repurchase agreements	483	522	(39)	373	422	(49)
Other borrowings	991	230	761	(35)	34	(69)
Total interest expense	7,921	4,889	3,032	1,261	1,817	(556)
Net interest income	$ 4,556	$ 877	$ 3,679	$ 1,084	$ 878	$ 206

ITEM 7A - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Management

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

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

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

The interest rate sensitivity position at December 31, 2006 is illustrated in the following table. The table presents the carrying amount of assets and liabilities in the periods they are expected to reprice or mature.

Table 3 - Interest Rate Sensitivity Gap Analysis
December 31, 2006
(dollars in thousands)

	Within 1 Year	> 1 Year to 3 Years	> 3 Year to 5 Years	> 5 Years	Total
Interest sensitive assets:					
Interest bearing deposits with other banks	$ 1,749	$ -	$ -	$ -	$ 1,749
Securities (1)	50,161	37,887	48,622	27,033	163,703
Loans (2)	306,269	127,155	74,747	35,719	543,890
Total interest sensitive assets	358,179	165,042	123,369	62,752	709,342
Interest sensitive liabilities:					
Checking and savings deposits	176,687	-	-	-	176,687
Money market deposits	50,948	-	-	-	50,948
Time deposits	179,367	68,007	26,611	23	274,008
Repurchase agreements	33,368	-	-	-	33,368
Federal Home Loan Bank advances	1,000	13,000		1,087	15,087
Trust preferred capital notes	-	-	-	20,619	20,619
Total interest sensitive liabilities	441,370	81,007	26,611	21,729	570,717
Interest sensitivity gap	$ (83,191)	$ 84,035	$ 96,758	$ 41,023	$ 138,625
Cumulative interest	$ (83,191)	$ 844	$ 97,602	$ 138,625	

sensitivity gap				
Percentage cumulative gap to total interest sensitive assets	(11.7)%	0.1%	13.8%	19.5%

(1) Securities based on amortized cost.
(2) Loans include loans held for sale and are net of unearned income.

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

Table 4 shows the estimated impact of changes in interest rates on net interest income as of December 31, 2006, assuming gradual and parallel changes in interest rates, and consistent levels of assets and liabilities.

Table 4 - Estimated Changes in Net Interest Income
(dollars in thousands)

	As of December 31, 2006	
Change in Interest Rates	Changes in Net interest Income (1) Amount	Percent
Up 2%	$ 388	1.33%
Up 1%	366	1.26
Down 1%	(462)	(1.59)
Down 2%	(603)	(2.07)

(1) Represents the difference between estimated net interest income for the next 12 months in the new interest rate environment and the current interest rate environment.

The projected changes in net interest income due to simulated changes in interest rates at December 31, 2006, were within established policy guidelines. Net interest income for the following twelve months is projected to increase when interest rates are higher than current rates and decrease when interest rates are lower than current rates.

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

Noninterest Income

Noninterest income was $8,458,000 in 2006, compared with $7,896,000 in 2005 and $6,510,000 in 2004. The increase of $562,000 for 2006 is largely due to an increase in trust fees, increases in deposit account service charge income, increased mortgage banking revenue, and income from bank owned life insurance policies acquired from Community First.

Fees from the management of trusts, estates, and asset management accounts totaled $3,374,000 in 2006, up from $3,012,000 in 2005, and $2,976,000 in 2004. These increases were due primarily to new account activity and fee structure changes.

Service charges on deposit accounts were $2,654,000 in 2006, up from $2,446,000 in 2005, and $2,411,000 in 2004. The increase for 2006 was due primarily to the acquisition of Community First.

Other fees and commissions were $1,163,000 in 2006, $1,078,000 in 2005, and $888,000 in 2004. Brokerage and insurance commissions, check cashing fees, non-customer ATM fees, debit and merchant credit card fees, safe deposit box rent, wire transfer fees, and letter of credit fees represent the majority of the income in this category. The growth in 2006 was largely due to increased debit card and wire transfer activity, both as a result of the acquisition of Community First. There was also an increase in letter of credit fees, due largely to one letter of credit. There was a decrease in check cashing fees from 2005 to 2006. This was due to discontinuance of a tax refund check cashing arrangement in which the Company collected a fee.

Mortgage banking income represents fees from originating, selling, and brokering residential mortgage loans. Mortgage banking income was $709,000 in 2006, $665,000 in 2005, and $612,000 in 2004. Changes in interest rates directly impact the volume of mortgage activity and, in turn, the amount of mortgage banking fee income earned.

Securities are sold from time to time for balance sheet management purposes or because an investment no longer meets the Company's policy requirements. Net gains on sales of securities were $62,000 in 2006, $53,000 in 2005, and $157,000 in 2004.

Other income was $496,000 in 2006, $642,000 in 2005, and $451,000 in 2004. In 2006, the Company obtained Bank Owned Life Insurance ("BOLI") with the Community First acquisition. BOLI income during 2006 was $100,000. Dividends from Virginia Bankers Insurance and Virginia Title Center increased $58,000, which also contributed to the increase in 2006. During 2005, the Company earned income of $375,000 from the sale of a bankcard processor, of which the Company was a member. Other income in 2004 included gains from the sale or disposal of real estate, including a former branch site.

Noninterest Expense

Noninterest expense was $20,264,000 in 2006, compared with $17,079,000 in 2005, and $15,011,000 in 2004.

Salary expense totaled $9,520,000 in 2006, $8,453,000 in 2005, and $6,795,000 in 2004. The increase in salaries for 2006 was due largely to the acquisition of Community First. Profit sharing and incentive expense was $867,000 in 2006, $866,000 in 2005, and $30,000 in 2004.

Pension and other employee benefit expense increased $531,000 from 2005 to 2006, and increased $276,000 from 2004 to 2005. The increase in 2006 was due primarily to the acquisition of Community First and an increase in pension and other employee benefit expenses. The 2005 increase was impacted by the opening of the Bedford County office and higher costs for employee medical benefits.

Occupancy and equipment expense increased $501,000 or 20.2% in 2006 over 2005, and increased $19,000 or .78% in 2005 over 2004. The increase in 2006 includes increases in depreciation expense of $127,000, rent of $110,000, building maintenance of $113,000, utilities and property taxes of $61,000, and software maintenance of $48,000. The increase in 2006 was due primarily to the acquisition of Community First.

Bank franchise tax expense was $651,000 in 2006, compared with $543,000 in 2005 and $555,000 in 2004. This expense is based in large part on the level of shareholders' equity at the end of the previous year. Accordingly, due to the higher level of shareholder's equity at December 31, 2006, related primarily to the Community First acquisition, bank franchise tax expense is expected to increase significantly in 2007.

Core deposit intangible expense was $414,000 in 2006, $353,000 in 2005, and $450,000 in 2004. The expense for 2005 and 2004 represents the amortization of the premium paid for deposits acquired at the Gretna office in 1995 and the Yanceyville office in 1996. The core deposit intangible associated with these acquisitions was amortized on a straight-line basis over a ten-year period. The amortization of the Gretna office deposits was complete in 2005 and those for the Yanceyville office were complete in 2006. The amortization of the core deposit intangible asset related to the Community First acquisition was $283,000 in 2006. Beginning April 2006, this asset is being amortized on a straight-line basis over ninety-nine months.

Other expense increased $917,000 or 28% from 2005 to 2006, and $224,000 or 7.3% from 2004 to 2005. The 2005 increase was due in large part to the opening of the new office in Bedford County, increased legal fees associated with loan collection and other activities, and higher expenses for electronic banking services. The increase for 2006 included $123,000 for the establishment of a reserve for unfunded loan commitments. The Company also experienced increases in Internet banking fees, external data processing fees, and telephone fees related to the acquisition of

Community First. Trust expense increased $117,000 in 2006 related to costs of outside investment management services and increased trust operational activity.

Income Tax Provision

Income taxes on 2006 earnings amounted to $5,119,000, resulting in an effective tax rate of 30.9%, compared to 29.1% in 2005 and 27.5% in 2004. The Company was subject to a blended Federal tax rate of 34.4% in 2006, 34.3% in 2005, and 34.1% in 2004. The major difference between the statutory rate and the effective rate results from income that is not taxable for Federal income tax purposes. The primary non-taxable income is that of state and municipal securities and industrial revenue bonds or loans.

FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL

Securities

The securities portfolio consists primarily of investments for which an active market exists. The securities portfolio generates income, plays a primary role in the management of interest rate sensitivity, provides a source of liquidity, and is used to meet collateral requirements.

Table 5 - Securities Portfolio

This table presents information on the amortized cost, maturities, and taxable equivalent yields of securities at the end of the last 3 years:

	2006		2005		2004	
(in thousands, except yields)	Amortized Cost	Taxable Equivalent Yield	Amortized Cost	Taxable Equivalent Yield	Amortized Cost	Taxable Equivalent Yield
Federal Agencies:						
Within 1 year	$ 36,969	3.92%	$ 27,005	2.77%	$ 12,012	3.98%
1 to 5 years	45,432	4.62	44,353	3.49	56,456	2.87
5 to 10 years	6,706	4.67	10,905	4.55	18,997	3.80
Over 10 years	-	-	-	-	-	-
Total	89,107	4.34	82,263	3.40	87,465	3.22
Mortgage-backed:						
Within 1 year	-	-	-	-	24	5.62
1 to 5 years	4,460	4.51	4,142	4.18	3,770	4.32
5 to 10 years	8,345	4.83	10,227	4.78	13,482	4.47
Over 10 years	6,805	5.06	6,908	4.11	12,033	4.32
Total	19,610	4.84	21,277	4.44	29,309	4.39
State and Municipal:						
Within 1 year	1,330	6.69	3,395	6.30	3,849	5.89
1 to 5 years	23,036	5.15	23,321	5.65	18,730	6.03
5 to 10 years	16,550	5.16	19,446	5.06	26,886	4.97
Over 10 years	5,179	6.03	3,040	6.15	4,257	6.15
Total	46,095	5.30	49,202	5.49	53,722	5.51
Other Securities:						
Within 1 year	1,005	6.06	4,511	6.09	2,706	6.03
1 to 5 years	1,485	3.32	3,514	4.91	8,070	5.58
5 to 10 years	-	-	-	-	-	-
Over 10 years	6,401	6.21	5,952	3.62	6,551	2.43
Total	8,891	5.71	13,977	4.74	17,327	4.46
Total portfolio	$ 163,703	4.74%	$ 166,719	4.26%	$ 187,823	4.17%

From 2005 to 2006, average securities increased from $170,400,000 to $173,600,000.

Index

Loans

The Company focuses its lending efforts on commercial loans to small and medium-sized businesses, construction and commercial real estate loans, equity lines, and residential mortgages. Average loans increased $98,900,000, or 23.9%, from 2005 to 2006. This increase is due largely to the acquisition of Community First. Average loans increased $10,900,000, or 2.7% from 2004 to 2005.

Loans held for sale are loans originated and in process of being sold to the secondary market. These loans are sold servicing released and totaled $1,662,000 at December 31, 2006, and $714,000 at December 31, 2005.

The following table provides loan balances, percentage of portfolio (excluding loans held for sale), and the percentage change since December 31, 2005 of loans booked by region.

	As of December 31, 2006		
(dollars in thousands)	Balance	Percentage of Portfolio	Percentage Change in Balance Since December 31, 2005
Danville region	$ 215,820	39.80%	(5.05)%
Lynchburg region	145,420	26.82	2,023.15
Southside region: Martinsville and Henry County	98,420	18.15	(9.01)
Halifax and Pittsylvania County	61,320	11.31	11.10
Greensboro area	21,220	3.92	28.04
Total loans	$ 542,200	100.00%	

The Company does not participate in highly leveraged lending transactions, as defined by bank regulations, and there are no loans of this nature recorded in the loan portfolio. The Company has no foreign loans in its portfolio. At December 31, 2006, the Company had no loan concentrations (loans to borrowers engaged in similar activities) which exceeded 10% of total loans.

Table 6 illustrates loans by type.

Table 6 - Loans

	As of December 31,				
	2006	2005	2004	2003	2002
(in thousands)					
Real estate:					
	$ 69,404	$ 50,092	$ 34,101	$ 12,790	$ 9,208

Construction and land development					
Commercial	186,639	142,968	147,653	136,395	115,077
1-4 family residential	131,126	94,405	91,672	94,032	92,334
Home equity	52,531	42,178	42,620	42,197	37,571
Total real estate	439,700	329,643	316,046	285,414	254,190
Commercial and industrial	91,511	76,735	75,847	97,114	120,164
Consumer	11,017	10,709	15,376	23,717	32,049
Total loans	$ 542,228	$ 417,087	$ 407,269	$ 406,245	$ 406,403

The Company conducted an equity line special promotion during 2006 which contributed to the growth in the home equity portfolio.

Table 7 presents the maturity schedule of selected loan types.

Table 7 - Scheduled Loan Maturities
December 31, 2006
(in thousands)

	Commercial and Agricultural	Real Estate Construction	Total
1 year or less	$ 56,001	$ 54,331	$ 110,332
1-5 years	30,740	14,564	45,304
After 5 years	4,770	509	5,279
Total	$ 91,511	$ 69,404	$ 160,915

Of the loans due after one year, $36,513 have predetermined interest rates and $14,070 have floating or adjustable interest rates.

Asset Quality and Credit Risk Management

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

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

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

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

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

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

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

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

The provision for loan losses was $58,000 in 2006, $465,000 in 2005, and $3,100,000 in 2004. The 2004 provision was largely attributable to a $4,500,000 loan secured by a hotel in a major North Carolina metropolitan area. The loan was determined to be impaired and was placed on nonaccrual status at December 31, 2004. This loan was sold at a discount, and the remaining balance charged-off in 2005. The amount charged-off was less than the specific reserve established for the loan, contributing to the reduction in the provision expense for 2005. The decrease in the provision for 2006 is due to an improvement in credit quality, as indicated by a reduction in nonperforming loans and by other internal measurements.

Loans charged-off net of recoveries totaled $501,000 in 2006, $2,300,000 in 2005, and $405,000 in 2004. The hotel loan discussed above represented $2,100,000 of the 2005 net charge-offs. Table 10 presents the Company's loan loss and recovery experience for the past five years.

The allowance for loan losses was $7,264,000 at December 31, 2006, compared with $6,109,000 and $8,000,000 at December 31, 2005 and 2004, respectively. The change in 2005 was due in large part to the hotel loan discussed above.

The allowance for loan losses is allocated to loan types based upon historical loss factors; risk grades on individual loans; portfolio analyses of smaller balance, homogenous loans; and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers and other lending staff; national and local economic trends and conditions; and concentrations of credit. The assessed risk of loan loss is higher in the commercial and consumer loan categories than in the residential real estate categories. Table 8 summarizes the allocation of the allowance for loan losses for the past five years.

Table 8 - Allocation of Allowance for Loan Losses
(dollars in thousands)

	For the year ended December 31,									
	2006		2005		2004		2003		2002	
(in thousands):	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans
Commercial (including commercial real estate)	$ 4,467	61%	$ 3,897	64%	$ 5,927	61%	$ 2,881	59%	$ 3,196	59%
Real estate-residential	2,119	37	1,462	33	1,231	35	848	35	781	33
Consumer	521	2	653	3	816	4	1,141	6	1,247	8
Unallocated	157	-	97	-	8	-	422	-	398	-
Balance at end of year	$ 7,264	100%	$ 6,109	100%	$ 7,982	100%	$ 5,292	100%	$ 5,622	100%

Table 9 - Asset Quality Ratios

	2006	2005	2004	2003	2002
Allowance to loans*	1.34%	1.46%	1.96%	1.3%	1.38%
Net charge-offs to year-end allowance	6.90	38.27	5.07	23.62	10.41
Net charge-offs to average loans	0.10	0.56	0.10	0.30	0.15
Nonperforming assets to total assets*	0.45	0.72	1.35	0.56	0.09
Nonperforming loans to loans*	0.63	1.02	1.99	0.82	0.13
Provision to net charge-offs	11.58	19.89	764.2	73.6	149.23
Provision to average loans	0.01	0.11	0.77	0.22	0.22
Allowance to nonperforming loans*	2.12 x	1.43 x	0.98 x	1.60 x	10.41 x

* - at year end

Table 10 - Summary of Loan Loss Experience
(in thousands)

	2006	2005	2004	2003	2002
Balance at beginning of period	$ 6,109	$ 7,982	$ 5,292	$ 5,622	$ 5,334
Allowance from Community First acquisition	1,598	-	-	-	-
Charge-offs:					
Construction and land development	1	-	-	-	-
Commercial	136	2,249	-	-	-
Residential real estate	163	35	85	71	26
Home equity	-	-	44	9	7
Total real estate	300	2,284	129	80	33
Commercial and industrial	354	76	169	1,004	343
Consumer	259	217	357	373	364
Total charge-offs	913	2,577	655	1,457	740
Recoveries:					
	1	-	-	-	-

Construction and land development					
Commercial	98	46	49	-	-
Residential real estate	11	3	-	-	3
Home equity	1	-	-	-	-
Total real estate	111	49	49	-	3
Commercial and industrial	108	11	45	105	28
Consumer	193	179	156	102	124
Total recoveries	412	239	250	207	155
Net charge-offs	501	2,338	405	1,250	585
Provision for loan losses	58	465	3,095	920	873
Balance at end of period	$ 7,264	$ 6,109	$ 7,982	$ 5,292	$ 5,622

Index

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

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

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt restructurings. Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming loans represented .63% of total loans at December 31, 2006, down from 1.02% at December 31, 2005.

Table 11 - Nonperforming Assets and Impaired Loans

	As of December 31,				
(in thousands)	2006	2005	2004	2003	2002
Nonaccrual loans:					
Real estate	$ 3,195	$ 4,098	$ 7,005	$ 1,870	$ 293
Commercial	151	12	853	1,236	-
Agricultural	-	-	12	8	8
Consumer	79	107	243	148	-
Total nonaccrual loans	3,425	4,217	8,113	3,262	301
Restructured loans	-	-	-	-	-
Loans past due 90 days and accruing interest:					
Real estate	-	46	-	-	-
Commercial	-	10	-	-	33
Agricultural	-	-	-	-	1
Consumer	-	-	-	53	205
Total past due loans	-	56	-	53	239
Total nonperforming loans	3,425	4,273	8,113	3,315	540
Foreclosed real estate	99	188	221	303	30
	$ 3,524	$ 4,461	$ 8,334	$ 3,618	$ 570

Total nonperforming assets

Liquidity

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

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

The Company has a line of credit with the FHLB, equal to 30% of the Company’s assets. This equated to a line of credit in the amount of $237,700,000 at December 31, 2006. Borrowings under this line at December 31, 2006 were $15,100,000. The line of credit at December 31, 2005 equaled $186,700,000, with borrowings outstanding under the line of $17,200,000. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB.

The Company had fixed-rate term borrowing contracts with the FHLB as of December 31, 2006, with the following final maturities:

Amount	Expiration Date
$1,000,000	2007
8,000,000	2008
5,000,000	2009
1,087,000	2014

The Company also has federal funds lines of credit established with two other banks in the amounts of $15,000,000 and $5,000,000, and has access to the Federal Reserve Bank’s discount window. There were no amounts outstanding under these facilities at December 31, 2006 or 2005.

Deposits

Average deposits increased $106,278,000 or 22% in 2006, after decreasing $8,900,000, or 1.8% in 2005. The increase in 2006 is due primarily to the acquisition of Community First. The Company experienced normal post-acquisition deposit runoff and allowed high-rate certificates of deposit issued by Community First to mature. During 2005, the Company focused primarily on growing its “core” deposits of checking, savings, and money market accounts, and less on growing or retaining higher-cost certificates of deposit (“time” deposits). Core deposits increased $6,500,000, or 2.3%, in 2005. Growth in core deposits provided the Company with lower-cost funding and helped solidify and expand its customer relationships. Average time deposits declined $15,500,000, or 7.6%, during 2005.

Table 12 - Deposits
(in thousands, except rates)

	As of December 31,					
	2006		2005		2004	
	Average Rate	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Demand deposits - noninterest bearing	$ 102,117	- %	$ 84,670	- %	$ 76,123	- %
Demand deposit - interest bearing	105,320	1.44	82,121	0.66	73,338	0.37
Money market	48,124	2.45	44,685	1.60	53,305	0.80
Savings	77,445	1.24	81,641	0.77	83,814	0.52
Time	255,856	3.79	189,467	2.65	204,945	2.36

$	588,862	2.27%	$	482,584	1.43%	$	491,525	1.21%

Index

Borrowings

Short-term borrowings consist of repurchase agreements and overnight borrowings from the FHLB. Repurchase agreements are borrowings collateralized by securities of the U.S. Government or its agencies and mature daily. The securities underlying these agreements remain under the Company's control.

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans, and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB.

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

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

The Trust Preferred Capital Notes mature thirty years from issuance, but the Company may redeem them, in whole or in part, after five years. They bear interest at a fixed rate of 6.66%. After five years, the rate will reset quarterly at the three-month LIBOR plus 1.35%.

Off-Balance Sheet Activities

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

Off-Balance Sheet Transactions	December 31, 2006	December 31, 2005
Commitments to extend credit	$ 155,038	$ 116,898
Standby letters of credit	3,125	2,625
Commitments to purchase securities	-	-

Mortgage loan rate-lock commitments	2,246	1,716

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

Index

Contractual Obligations

The following items are contractual obligations of the Company as of December 31, 2006 (in thousands):

		Payments Due by Period			
Contractual Obligations	Total	Under 1 Year	1-3 Years	3-5 Years	More than 5 years
FHLB advances	$ 15,087	$ 1,000	$ 13,000	$ 0	$ 1,087
Repurchase agreements	33,368	33,368	-	-	-
Operating leases	1,126	320	692	62	52
Trust Preferred Securities	27,484	1,373	2,746	2,746	20,619

Shareholders' Equity

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

The Company declared and paid quarterly dividends totaling $.87 and $.83 per share of common stock in 2006 and 2005, respectively. Cash dividends in 2006 totaled $5,210,000 and represented a 45.6% payout of 2006 net income, compared to 45.3% in 2005 and 55.1% in 2004. The Company intends to pay dividends that are competitive in the banking industry while maintaining an adequate level of capital to support growth.

One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Shareholders' equity was 12.21% of assets at December 31, 2006 and 11.78% at December 31, 2005. In addition to this measurement, banking regulators have defined minimum regulatory capital ratios for financial institutions. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and off-balance sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance sheet assets in relation to their perceived risk. Under the guidelines, capital strength is measured in two tiers. Tier I capital consists primarily of shareholder's equity, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the total of Tier I and Tier II capital. Another indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier I capital by average quarterly assets less intangible assets.

The regulatory guidelines require that minimum total capital (Tier I plus Tier II) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier I capital. At December 31, 2006, the Company's Tier I and total capital ratios were 16.18% and 17.45%, respectively. At December 31, 2005, these ratios were 16.25% and 17.57%, respectively. The ratios for both years exceeded the regulatory requirements. The Company's leverage ratios were 12.15% and 11.94% at December 31, 2006 and 2005, respectively. The leverage ratio has a regulatory minimum of 4%, with most institutions required to maintain a ratio of 4-5%, depending upon risk profiles and other factors.

As mandated by bank regulations, the following five capital categories are identified for insured depository institutions: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." These regulations require the federal banking regulators to take prompt corrective action with respect to insured depository institutions that do not meet minimum capital requirements. Under the regulations, well capitalized institutions must have Tier I risk-based capital ratios of at least 6%, total risk-based capital ratios of at least 10%, leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of December 31, 2006 and 2005, that the Company met the requirements to be considered "well capitalized."

Impact of Inflation and Changing Prices

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

ITEM 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Table 14 - Quarterly Financial Results
(in thousands, except per share amounts)

2006	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	$ 11,925	$ 12,151	$ 12,146	$ 8,848
Interest expense	4,752	4,645	4,435	2,829
Net interest income	7,173	7,506	7,711	6,019
Provision for loan losses	(547)	125	354	126
Net interest income after provision for loan losses	7,720	7,381	7,357	5,893
Noninterest income	2,152	2,138	2,267	1,901
Noninterest expense	5,408	5,117	5,356	4,383
Income before income tax provision	4,464	4,402	4,268	3,411
Income tax provision	1,547	1,301	1,266	1,005
Net income	$ 2,917	$ 3,101	$ 3,002	$ 2,406
Per common share:				
Net income - basic	$ 0.47	$ 0.50	$ 0.49	$ 0.44
Net income - diluted	0.47			