AMERICAN NATIONAL BANKSHARES INC
Form 10-K/A
March 25, 2009
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K/A

This Amendment No.1 to Form 10-K filed with the Commission on March 25, 2009 corrects the Consolidated Statements of Cash Flows included in Item 8 on page 43, which omitted figures in the original submission due to a table transmission error during the Edgarizing process.

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

For the fiscal year ended December 31, 2008

Commission file number 0-12820

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

Virginia	54-1284688
(State of incorporation)	(I.R.S. Employer Identification No.)
628 Main Street, Danville, VA	24541
(Address of principal executive offices)	(Zip Code)

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

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

Title of Each Class	Name of Exchange on Which Registered
Common Stock, $1 par value	The Nasdaq Stock Market LLC (Nasdaq Global Select Market)

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes 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. £

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company 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, 2008, based on the closing price, was $95,898,967.

The number of shares of the registrant's common stock outstanding on March 13, 2009 was 6,079,161.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held on May 19, 2009, are incorporated by reference in Part III of this report.

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CROSS REFERENCE INDEX

*Certain information required by Item 10 is incorporated herein by reference to the information that appears under the headings “Election of Directors,” “Election of Directors – Board Members Serving on Other Publicly Traded Company Boards of Directors,” “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 2009 Annual Meeting of Shareholders. The information required by Item 401 of regulation S-K on executive officers is disclosed herein.

The information required by Item 11 is incorporated herein by reference to the information that appears under the headings “Compensation Discussion and Analysis,” “Compensation Committee Interlocks and Insider Participation,” and “Compensation Committee Report” in the Registrant’s Proxy Statement for the 2009 Annual Meeting of Shareholders.

The information required by Item 12 is incorporated herein by reference to the information that appears under the heading “Security Ownership” in the Registrant’s Proxy Statement for the 2009 Annual Meeting of Shareholders. The information required by Item 201(d) of Regulation S-K is disclosed herein. See Item 5, “Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.”

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The information required by Item 13 is incorporated herein by reference to the information that appears under the headings “Related Party Transactions” and “Election of Direectors - Board Independence" in the Registrant's Proxy Statement for the 2009 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 2009 Annual Meeting of Shareholders.

PART I

Forward-Looking Statements

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

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

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

ITEM 1 – BUSINESS

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

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

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Competition and Markets

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

The Southern Virginia market, in which the Company has a significant presence, is under economic pressure. The region's economic base has historically been weighted toward the manufacturing sector. Increased global competition has negatively impacted the 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. Companies within these industries, especially furniture manufacturing, have also closed plants for reasons similar to those noted above. Additional declines in manufacturing production and unemployment could negatively impact the ability of certain borrowers to repay loans. Also, the current economic and credit crisis, which is resulting in rising unemployment and increasing bankruptcies, foreclosures and bank failures nationally, may further intensify the economic pressure in our markets.

Supervision and Regulation

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

American National Bankshares Inc.

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

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

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

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

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American National Bank and Trust Company

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

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

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

Dividend Restrictions and Capital Requirements

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

FDIC Insurance

American National Bank and Trust Company's deposits are currently insured up to the following amounts per insured depositor by the Deposit Insurance Fund of the FDIC:

- $250,000 for accounts other than retirement accounts and noninterest-bearing transaction accounts;
- $250,000 for retirement accounts; and
- Unlimited coverage for noninterest-bearing transaction accounts, which applies to deposits in institutions such as American National Bank and Trust Company that are participating in the FDIC's Temporary Liquidity Guarantee Program. For FDIC coverage purposes, interest-bearing checking accounts with an interest rate of 0.50% or less are included in the definition of noninterest-bearing transaction accounts.

Effective January 1, 2010, the standard FDIC coverage limit per depositor will return to the prior amount of $100,000 for all deposit categories except for retirement accounts, which will continue to be insured up to $250,000 per insured depositor.

On October 14, 2008, the FDIC announced the Temporary Liquidity Guarantee Program ("TLG Program") to strengthen confidence and encourage liquidity in the banking system. The TLG Program consists of two components: a temporary guarantee of newly-issued senior unsecured debt the ("Debt Guarantee Program") and a temporary unlimited guarantee of funds in noninterest-bearing transaction accounts at FDIC-insured institutions the ("Transaction Account Guarantee Program"). The Company is participating in the Transaction Account Guarantee Program but is not participating in the Debt Guarantee Program where it has the option of issuing certain non-guaranteed senior unsecured debt.

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.

Under the risk-based deposit premium assessment system of the FDIC, the assessment rates for an insured depository institution vary according to the level of risk incurred in its activities. To arrive at an assessment rate for a banking institution, the FDIC places it in one of four risk categories (referred to as Risk Categories I, II, III and IV) determined by reference to its capital levels and supervisory ratings. The assessment rates in 2008 ranged, on an annual basis, from 5 to 43 basis points, depending on the insured institution's risk category as described above. Commencing in 2009, assessment rates increased by 7 basis points in each risk category for the first quarter of 2009. Further, for institutions such as American National Bank and Trust Company that have elected to provide unlimited FDIC coverage for noninterest-bearing transaction accounts, an additional assessment at the annual rate of 10 basis points is due in 2009 for the amount of balances in non-interest bearing transaction accounts that exceed the existing coverage limit of $250,000 for deposit accounts other than retirement accounts and noninterest-bearing transaction accounts.

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Under a revised assessment schedule effective April 1, 2009, The FDIC has set new initial base assessment rates that range, on an annual basis, from 12 to 45 basis points per $100 of assessable deposits, depending on the insured institution's risk category as described above. These initial base assessment rates are subject to possible adjustments, including (1) for all risk categories, a potential increase for unsecured liabilities and potential decrease for long-term unsecured debt and (2) for all risk categories, other than Risk Category I, a potential increase for brokered deposits.

In February 2009, The FDIC proposed that an emergency special assessment up to 20 basis points per $100 of deposits be collected from all insured institutions in September 2009 and further proposed that additional special assessments of up to 10 basis points each be collected as considered necessary thereafter to maintain public confidence in federal deposit insurance.

The level of FDIC insurance premium assessments in 2007 and 2008 for American National Bank and Trust Company was reduced by a cumulative total of $499,000 though application of a one-time premium assessment credit that resulted from the provisions of the Federal Deposit Insurance Reform Act of 2005.

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, 2008 and 2007, that the Company met the requirements for being classified as "well capitalized."

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

Community Reinvestment and Consumer Protection Laws

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

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.

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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.

Emergency Economic Stabilization Act of 2008

In accordance with its stated purpose of restoring liquidity and stability to the financial system of the United States, the Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program ("TARP"), under which the United States Department of the Treasury ("UST") is authorized to purchase preferred stock from qualified financial institutions. The Company meets the requirements to be considered a qualified financial institution. Under TARP, for organizations like the Company, the federal government's purchase limitation is generally defined as 3% of risk-weighted assets, or about $18 million for the Company. The terms of the preferred stock generally provide that:

- Cumulative dividends will be paid at a rate of 5% for the first five years and 9% thereafter;
- Any increase in the dividend rate paid on common stock during the first three years will require the consent of the UST;
- Any repurchase of common stock will require the consent of the UST;
- Conditions and limitations will be placed on executive compensation; and
- UST will receive warrants, with a term of 10 years, to purchase a number of shares of common stock having an aggregate market price equal to 15% of the preferred stock amount on the day of investment.

After considering the appropriateness of applying under UST's capital purchase program, the Company has elected not to participate. The Company believes it has sufficient capital to meet the growth plans and credit needs of the communities it serves without government support.

Employees

At December 31, 2008, the Company employed 258 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.

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Executive Officers of the Registrant

The following lists, as of December 31, 2008, the named executive officers of the registrant, their ages, and their positions.

Name	Age	Position
Charles H. Majors	63	President and Chief Executive Officer of the Company.
Neal A. Petrovich *	46	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; prior thereto, Senior Vice President of SouthTrust Bank.
Jeffrey V. Haley	48	Senior Vice President of American National Bankshares Inc.; President of Trust and Financial Services and Executive Vice President of American National Bank and Trust Company since July 2008; prior thereto, 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.
R. Helm Dobbins	57	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.
S. Cabell Dudley, Jr.	63	Senior Vice President of American National Bankshares Inc. since December 2008; Executive Vice President and Chief Lending Officer of American National Bank and Trust Company since July 2008; prior thereto Senior Vice President and Commercial Relationship Manager since March 2006, prior thereto Senior Vice President of Wachovia Bank.
Dabney T. P. Gilliam, Jr.	54	Senior Vice President of American National Bankshares Inc. since December 2008; Executive Vice President and Chief Administration Officer of American National Bank and Trust Company since July 2008; prior thereto Senior Vice President of American National Bank and Trust Company since February 2007; prior thereto Chief Financial Officer of RACO, Inc. from January 2006 to February 2007; prior thereto Senior Vice President, Senior Loan Officer and Chief Banking Officer of American National Bank and Trust Company.

* Mr. Petrovich resigned from the Company in February 2009.

ITEM 1A – RISK FACTORS

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

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

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

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

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

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

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

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

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

A downturn in the real estate market could negatively affect the Company's business because significant portions of its loans are secured by real estate (approximately 81% as of December 31, 2008). The ability to recover on defaulted loans by selling the real estate collateral could then be diminished and the Company would be more likely to suffer losses on defaulted loans.

Substantially all of the Company's real property collateral is located in its market area. If there is a significant decline in real estate values, especially in our market area, the collateral for loans would provide significantly 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.

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

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

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

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

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

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

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

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

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

The Company is exposed to operational risk.

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

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

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

Changes in accounting standards could impact reported earnings.

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

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

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

Recent Negative Developments in the Financial Industry and Credit Markets May Adversely Affect the Company's Operations and Results.

Negative developments in the latter half of 2007 and during 2008 in the credit and securitization markets have resulted in uncertainty in the financial markets in general with the expectation of the general economic downturn continuing into 2009. Loan portfolio quality has deteriorated at many institutions, and the Company also has experienced some deterioration. In addition, the value of real estate collateral supporting many home mortgages, including mortgages held by the Company, has declined and may continue to decline. Bank and bank holding company stock prices have been negatively affected, as has the ability of banks and bank holding companies to raise capital or borrow in the debt markets. As a result, the potential exists for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be active in responding to concerns and trends identified in examinations. Negative developments in the financial industry and credit markets, and the impact of new legislation in response to those developments, may negatively impact the Company's operations by restricting its business operations, including its ability to originate or sell loans, and adversely impact its financial performance. In addition, these risks could affect the value of the Company's loan portfolio as well as the value of its investment portfolio, which would also negatively affect its financial performance.

ITEM 2 – PROPERTIES

As of December 31, 2008, the Company maintained twenty banking offices located in Danville, Pittsylvania County, Martinsville, Henry County, Halifax County, Lynchburg, Bedford County, Campbell County, and Nelson County in Virginia and Caswell County in North Carolina. The Company also operates a loan production office in Greensboro, North Carolina.

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

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

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

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The Company purchased an office building in 2008 at 445 Mount Cross Road in Danville, Virginia where it consolidated two banking offices in January 2009 and gained additional administrative space.

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

ITEM 3 – LEGAL PROCEEDINGS

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

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

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

PART II

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

The Company's common stock is traded on the NASDAQ Global Select Market under the symbol "AMNB." At December 31, 2008, the Company had 1,662 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
2008	High	Low	Per Share
4th quarter	$ 18.25	$ 14.01	$ 0.23
3rd quarter	18.20	15.80	0.23
2nd quarter	22.00	17.45	0.23
1st quarter	22.64	18.65	0.23
			$ 0.92

	Closing Price		Dividends
2007	High	Low	Per Share
4th quarter	$ 22.76	$ 19.40	$ 0.23
3rd quarter	22.96	20.50	0.23

2nd quarter	23.08	22.15	0.23
1st quarter	23.68	22.02	0.22
			$ 0.91

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The table below presents share repurchase activity during the quarter ended December 31, 2008.

	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, 2008	4,500	$ 16.03	4,500	92,350
November 1-30, 2008	1,100	17.07	1,100	91,250
December 1-31, 2008	1,500	17.05	1,500	89,750
	7,100	$ 16.40	7,100	

Stock Compensation Plans

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

The 2008 Plan is administered by a Committee of the Board of Directors of the Company comprised of independent directors. Under the 2008 Plan, the Committee determines which employees will be granted restricted stock awards and options, whether such options will be incentive or non-statutory 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 become 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. Restricted stock would be granted under terms and conditions established by the Committee.

Stock options become 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. As of December 31, 2008, 159,610 shares remain exercisable under the 1997 Option Plan and 14,750 shares are exercisable under the 2008 Plan. There were 59,000 stock options awarded in 2008. All options granted in 2008 had multi-year vesting schedules to enhance employee retention.

	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 Compensation Plans
Equity compensation plans approved by shareholders	218,610	$ 20.31	441,000
Equity compensation plans not approved by shareholders	-	-	-
Total	218,610	$ 20.31	441,000

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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, 2008. The cumulative total return was calculated taking into consideration changes in stock price, cash dividends, stock dividends, and stock splits since December 31, 2003. The indexes are the NASDAQ Composite Index; the SNL Bank $500 Million-$1Billlion Index, which includes bank holding companies with assets of $500 million to $1 billion and is published by SNL Financial, LC.

American National Bankshares Inc.

	Period Ending					
Index	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08
American National Bankshares Inc.	100.00	95.98	95.46	99.37	88.72	79.51
NASDAQ Composite	100.00	108.59	110.08	120.56	132.39	78.72
SNL Bank $500M-$1B	100.00	113.32	118.18	134.41	107.71	69.02

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ITEM 6 - SELECTED FINANCIAL DATA

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

(in thousands, except per share amounts and ratios)	2008	2007	2006	2005	2004
Results of Operations:					
Interest income	$ 42,872	$ 48,597	$ 45,070	$ 32,479	$ 30,120
Interest expense	15,839	19,370	16,661	8,740	7,479
Net interest income	27,033	29,227	28,409	23,739	22,641
Provision for loan losses	1,620	403	58	465	3,095
Noninterest income	7,913	8,822	8,458	7,896	6,510
Noninterest expense	22,124	21,326	20,264	17,079	15,011
Income before income tax provision	11,202	16,320	16,545	14,091	11,045
Income tax provision	3,181	4,876	5,119	4,097	3,032
Net income	$ 8,021	$ 11,444	$ 11,426	$ 9,994	$ 8,013
Period-end Balances:					
Securities	$ 140,816	$ 157,149	$ 162,621	$ 165,629	$ 188,163
Loans, net of unearned income	571,110	551,391	542,228	417,087	407,269
Deposits	589,138	581,221	608,528	491,651	485,272
Assets	789,184	772,288	777,720	623,503	619,065
Shareholders' equity	102,300	101,511	94,992	73,419	71,000
Shareholders' equity - tangible (a)	77,757	76,591	69,695	73,287	70,516
Per Share Information:					
Earnings - basic	$ 1.32	$ 1.86	$ 1.91	$ 1.83	$ 1.43
Earnings - diluted	1.31	1.86	1.90	1.81	1.42
Dividends	0.92	0.91	0.87	0.83	0.79
Book value	16.81	16.59	15.42	13.49	12.86
Book value - tangible (a)	12.78	12.52	11.31	13.47	12.77
Ratios:					
Return on average assets	1.02%	1.48%	1.51%	1.61%	1.26%
Return on average shareholders' equity	7.79	11.69	12.72	13.95	11.15
Return on average tangible equity (b)	10.60	16.09	16.60	14.35	11.72
Net interest margin - taxable equivalent	3.87	4.24	4.20	4.17	3.90
Average shareholders' equity / average assets	13.10	12.65	11.85	11.57	11.34

Dividend payout ratio	69.89	48.82	45.58	45.39	55.13
Net charge-offs to average loans	0.21	0.05	0.10	0.56	0.10
Allowance for loan losses to period-end loans	1.37	1.34	1.34	1.46	1.96
Nonperforming assets to total assets	0.91	0.42	0.45	0.72	1.35

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

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

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

RECLASSIFICIATION

In certain circumstances, reclassifications have been made to prior period information to conform to the 2008 presentation.

CRITICAL ACCOUNTING POLICIES

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

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

Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

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

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

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

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Goodwill Impairment

The Company tests goodwill on an annual basis or more frequently if events or circumstances indicate that there may have been impairment. If the carrying amount of goodwill exceeds its implied fair value, the Company would recognize an impairment loss in an amount equal to that excess. The goodwill impairment test requires management to make judgments in determining the assumptions used in the calculations. The goodwill impairment testing conducted by the Company in 2008 indicated that goodwill is not impaired and is properly recorded in the financial statements.

NON-GAAP PRESENTATIONS

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

EXECUTIVE OVERVIEW

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

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

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

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

Mission

We provide quality financial services with exceptional customer service.

Vision

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

Guiding Principles

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

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

- conduct our work with integrity and professionalism.

RESULTS OF OPERATIONS

Net Interest Income

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

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Net interest income decreased $2,226,000, or 7.4% from 2007 to 2008, following a $757,000, or 2.6% increase in 2007 from 2006 levels. The decrease in 2008 was primarily due to an 8.7% decline in the net interest margin from 4.24% in 2007 to 3.87% in 2008, the effect of which was partially offset by a 1.6% increase in the level of average interest earning assets. The increase in 2007 was primarily due to balance sheet growth including the acquisition of Community First Financial Corporation in April 2006. Additionally, purchase accounting adjustments from the Community First acquisition had a positive impact on net interest income in 2007. Payoffs of acquired loans accounted for under American Institute of Certified Public Accountants Statement of Position 03-3 resulted in $571,000 of interest income in 2007. Interest income related to the valuation of other loans acquired from Community First was $536,000 in 2008 and 2007. Similarly, interest expense related to the valuation of acquired deposits was $0 and $88,000 in 2008 and 2007, respectively. The net interest margin decreased from 4.24% in 2007 to 3.87% in 2008, after increasing from 4.20% in 2006, due primarily to the fact that loans, the largest component of earning assets, reprice at a much faster pace than deposits in interest bearing liabilities. During 2008, the Federal Open Market Committee of the Federal Reserve Board reduced the intended federal funds rate seven times from 4.25% to 0.25%. This had a dramatic effect on the Company’s net interest margin.

To meet its funding needs for the Community First acquisition, the Company issued $20,619,000 of Trust Preferred Securities during the second quarter of 2006. Interest expense associated with these securities was $1,373,000 for 2008 and 2007 and $1,007,000 for 2006.

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The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the years 2006 through 2008. 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		
	2008	2007	2006	2008	2007	2006	2008	2007	2006
Loans:									
Commercial	$ 91,117	$ 89,673	$ 84,676	$ 5,515	$ 6,980	$ 6,481	6.05%	7.78%	7.65%
Real Estate	467,508	449,683	416,530	29,712	33,621	29,813	6.36	7.48	7.16
Consumer	8,774	10,420	12,287	795	975	1,152	9.06	9.36	9.38
Total loans	567,399	549,776	513,493	36,022	41,576	37,446	6.35	7.56	7.29
Securities:									
Federal agencies	45,660	68,521	94,589	2,215	3,032	3,745	4.85	4.42	3.96
Mortgage-backed	47,997	25,406	21,197	2,433	1,255	988	5.07	4.94	4.66
State and municipal	45,573	46,069	46,735	2,505	2,530	2,624	5.50	5.49	5.61
Other	6,141	7,484	11,059	277	438	621	4.51	5.85	5.62
Total securities	145,371	147,480	173,580	7,430	7,255	7,978	5.11	4.92	4.60
Deposits in other banks	9,239	13,431	12,922	301	679	620	3.26	5.06	4.80
Total interest earning assets	722,009	710,687	699,995	43,753	49,510	46,044	6.06	6.97	6.58
Nonearning assets	63,859	62,952	57,807						
Total assets	$ 785,868	$ 773,639	$ 757,802						
Deposits:									
Demand	$ 109,492	$ 107,834	$ 105,320	803	1,550	1,513	0.73	1.44	1.44
Money market	53,659	52,843	48,124	1,011	1,429	1,180	1.88	2.70	2.45
Savings	61,620	66,246	77,445	331	845	963	0.54	1.28	1.24
Time	258,773	261,286	255,856	10,135	11,711	9,693	3.92	4.48	3.79
Total deposits	483,544	488,209	486,745	12,280	15,535	13,349	2.54	3.18	2.74
Customer repurchase agreements	52,264	48,088	40,970	1,377	1,841	1,384	2.63	3.83	3.38
Other short-term borrowings	9,818	346	1,240	252	19	69	2.57	5.49	5.56

Long-term borrowings	34,235	32,245	31,847	1,930	1,975	1,859	5.64	6.12	5.84
Total interest bearing liabilities	579,861	568,888	560,802	15,839	19,370	16,661	2.73	3.40	2.97
Noninterest bearing demand deposits	98,157	102,003	102,117						
Other liabilities	4,933	4,894	5,059						
Shareholders' equity	102,917	97,854	89,824						
Total liabilities and shareholders' equity	$ 785,868	$ 773,639	$ 757,802						
Interest rate spread							3.33%	3.57%	3.61%
Net interest margin							3.87%	4.24%	4.20%
Net interest income (taxable equivalent basis)				27,914	30,140	29,383			
Less: Taxable equivalent adjustment				881	913	974			
Net interest income				$ 27,033	$ 29,227	$ 28,409			

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

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

	2008 vs. 2007			2007 vs. 2006		
		Change Attributable to			Change Attributable to	
Interest income	Increase (Decrease)	Rate	Volume	Increase (Decrease)	Rate	Volume
Loans:						
Commercial	$ (1,465)	$ (1,576)	$ 111	$ 499	$ 111	$ 388
Real Estate	(3,909)	(5,200)	1,291	3,808	1,367	2,441
Consumer	(180)	(30)	(150)	(177)	(2)	(175)
Total loans	(5,554)	(6,806)	1,252	4,130	1,476	2,654
Securities:						
Federal agencies	(817)	270	(1,087)	(713)	404	(1,117)
Mortgage-backed	1,178	34	1,144	267	62	205
State and municipal	(25)	2	(27)	(94)	(57)	(37)
Other securities	(161)	(90)	(71)	(183)	25	(208)
Total securities	175	216	(41)	(723)	434	(1,157)
Deposits in other banks	(378)	(201)	(177)	59	34	25
Total interest income	(5,757)	(6,791)	1,034	3,466	1,944	1,522
Interest expense						
Deposits:						
Demand	(747)	(770)	23	37	1	36
Money market	(418)	(440)	22	249	127	122
Savings	(514)	(459)	(55)	(118)	24	(142)
Time	(1,576)	(1,464)	(112)	2,018	1,808	210
Total deposits	(3,255)	(3,133)	(122)	2,186	1,960	226
Customer repurchase agreements	(464)	(613)	149	457	198	259
Other borrowings	188	(427)	615	66	95	(29)
Total interest expense	(3,531)	(4,173)	642	2,709	2,253	456
Net interest income	$ (2,226)	$ (2,618)	$ 392	$ 757	$ (309)	$ 1,066

Noninterest Income

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

Noninterest income was $7,913,000 in 2008, down 10.3% from 2007, resulting primarily from decreases in trust fees, service charges on deposit accounts, mortgage banking income, brokerage, income from investment in insurance companies, and losses of $450,000 on securities.

Noninterest income was $8,822,000 in 2007, up 4.3% over 2006. Increases in trust fees, mortgage banking income, brokerage, and other fee income were partially offset by decreases in deposit account service charges and by a $362,000 impairment charge on securities.

Fees from the management of trusts, estates, and asset management accounts totaled $3,467,000 in 2008, down from $3,578,000 in 2007 and up from $3,374,000 in 2006. These changes were due primarily to market value decline or appreciation in the securities markets as a substantial proportion of these fees are earned as a percentage of the account balances.

Service charges on deposits accounts decreased 8.2% in 2008 and 4.6% in 2007, primarily due to reduced customer overdraft activity.

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Other fees and commissions primarily include income generated from the Company's debit card, ATM, safe deposit box, merchant credit card, and wire transfer services. Insurance commission revenue is also included in this category. Other fees and commissions were $ 857,000 in 2008, $786,000 in 2007, and $744,000 in 2006. The increase in both 2008 and 2007 is primarily the result of growth in debit card revenue due to increased customer debit card activity.

Mortgage banking income represents fees from originating and selling residential mortgage loans. Mortgage banking income was $788,000 in 2008, $954,000 in 2007, and $709,000 in 2006. 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 losses on sales or calls of securities were $450,000 in 2008, resulting from $51,000 in gains and $501,000 in losses. Net gains on sales or calls of securities were $135,000 in 2007 and $62,000 in 2006.

During 2008, the Company sold all remaining shares it held in Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Corporation ("FHLMC") preferred stock, resulting in a loss of $501,000 which is referenced above. In December 2007, the Company recorded a $362,000 impairment charge relating to its holdings of FHLMC and FNMA preferred stock. The impairment charges are recorded as a reduction of noninterest income.

Other noninterest income was $496,000 in 2008, $650,000 in 2007, and $496,000 in 2006. The 2008 decline resulted primarily from a $138,000 reduction in revenue from the Company's investments in Bankers Insurance, LLC and Virginia Title Center, LLC. The 2007 increase was largely the result of increased dividend revenue from the Company's two insurance company investments. Additionally, a full year of revenue from the Company's bank owned life insurance ("BOLI") policies increased this income category by $34,000 in 2007.

Table 3 - Noninterest income
(in thousands)

	Years Ended December 31, 2008	2007	2006
Trust fees	$ 3,467	$ 3,578	$ 3,374
Service charges on deposit accounts	2,324	2,531	2,654
Other fees and commissions	857	786	744
Mortgage banking income	788	954	709
Brokerage fees	431	550	419
Securities gains (losses), net	(450)	135	62
Impairment of securities	-	(362)	-
Investment in insurance companies	142	280	220
	136	134	100

Bank owned life insurance			
Check order charges	129	127	113
Other	89	109	63
	$ 7,913	$ 8,822	$ 8,458

Noninterest Expense

Noninterest expense consists primarily of personnel, occupancy, equipment, and other expenses. Noninterest expense was $22,124,000 in 2008, up 3.7% over 2007, due primarily to increased health insurance costs and provision for unfunded lending commitments. Noninterest expense was $21,326,000 in 2007, up 5.2% over 2006, due primarily to increased staff levels and a full year of expenses associated with the April 2006 Community First acquisition.

Personnel expenses comprise over half of the Company's noninterest expense. Combined salary and benefits expense increased 2.9% in 2008 when compared to 2007. Employee insurance costs represent 73% of the 2008 increase. Personnel expenses increased 3.4% in 2007 when compared to 2006. Combined higher staff levels and a full year of the expenses associated with the Community First acquisition were partially offset by a reduction in profit sharing and incentive compensation expense. Profit sharing and incentive expense was $0 in 2008, $287,000 in 2007, and $867,000 in 2006.

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Occupancy and equipment expense increased form $3,527,000 in 2007 to $3,701,000 in 2008, an increase of 4.9%. The increase was primarily due to increases in software maintenance and depreciation. Occupancy and equipment expense increased from $2,977,000 in 2006 to $3,527,000 in 2007, an increase of 18.5%. The increase was due in large part to a full year of expenses associated with the Community First acquisition, increased building maintenance costs, the expenses of two new branch offices, and costs related to new technology for check processing and network security.

Bank franchise tax expense was $694,000 in 2008, compared with $663,000 in 2007 and $651,000 in 2006. This expense is based in large part on the level of shareholders' equity.

Core deposit intangible expense was $377,000 in 2008 and 2007, and $414,000 in 2006. The 2008 and 2007 expense consists entirely of amortization of the core deposit intangible asset from the Community First acquisition; beginning April 2006, this asset is being amortized on a straight-line basis over ninety-nine months. Core deposit intangible expense in 2006 also includes amortization of the core deposit intangible asset arising from a 1996 branch purchase.

Other noninterest expense consists of a variety of expenses including those related to professional services, advertising and marketing, FDIC assessment, telephone systems, ATM and Internet banking services, trust services, supplies, Federal Reserve services, and provision for unfunded lending commitments. Other noninterest expense totaled $4,559,000 in 2008, $4,322,000 in 2007, and $4,196,000 in 2006. Other noninterest expense increased 5.5% in 2008, and was largely the result of an increase in the provision for unfunded lending commitments of $297,000 over the amount in 2007. Other noninterest expense increased 3.0% in 2007, and was largely the result of higher trust service costs and a full year of expenses associated with the acquisition of Community First.

Table 4 - Noninterest expense
(in thousands)

	Years Ended December 31, 2008	2007	2006
Salaries	$ 9,792	$ 9,688	$ 9,520
Employee benefits	3,001	2,749	2,506
Occupancy and equipment	3,701	3,527	2,977
Bank franchise tax	694	663	651
Core deposit intangible amortization	377	377	414
Telephone	433	395	361
Provision for unfunded lending commitments	324	27	123
Stationery and printing supplies	306	335	395
Trust services contracted	278	237	187
Postage	245	273	240
ATM and VISA network fees	243	329	303
Director fees	225	205	194
	203	300	267

Advertising and marketing			
Legal	194	119	148
Internet banking fees	193	194	173
FDIC assessment	180	87	84
Regulatory assessments	179	187	170
Automobile	174	147	103
Auditing	173	168	142
Loan expenses	140	108	67
Contributions	118	120	138
Dues and subscriptions	113	106	108
Courier service	107	106	97
Correspondent bank fees	86	161	161
Other	645	718	735
	$ 22,124	$ 21,326	$ 20,264

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Income Taxes

Income taxes on 2008 earnings amounted to $3,181,000, resulting in an effective tax rate of 28.4%, compared to 29.9% in 2007 and 30.9% in 2006. The Company was subject to a statutory, blended, Federal tax rate of 34.1% in 2008, 34.4% in 2007, and 34.4% in 2006. The major difference between the statutory rate and the effective rate results from income that is not taxable for Federal income tax purposes. The primary non-taxable income is that of state and municipal securities and industrial revenue bonds or loans.

Impact of Inflation and Changing Prices

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

Market Risk Management

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

Interest Rate Risk Management

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

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

A balance sheet is considered asset sensitive when its earning assets (loans and securities) reprice faster or to a greater extent than its liabilities (deposits and borrowings). An asset sensitive balance sheet will produce more net interest income when interest rates rise and less net interest income when they decline. Based on the Company's simulation analysis, management believes the Company's interest sensitivity position at December 31, 2008 is asset sensitive.

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The interest rate sensitivity position at December 31, 2008 is illustrated in the following table. The carrying amounts of assets and liabilities are presented in the periods they are expected to reprice or mature.

Table 5 - Interest Rate Sensitivity Gap Analysis
December 31, 2008
(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	$ 1,112	$ -	$ 8,000	$ -	$ 9,112
Securities	15,116	41,839	16,802	67,059	140,816
Loans (1)	347,594	99,879	73,248	52,153	572,874
Total interest sensitive assets	363,822	141,718	98,050	119,212	722,802
Interest sensitive liabilities:					
Checking and savings deposits	175,756	-	-	-	175,756
Money market deposits	56,615	-	-	-	56,615
Time deposits	181,352	49,873	29,839	-	261,064
Customer repurchase agreements	51,741	-	-	-	51,741
Federal Home Loan Bank advances	7,850	5,000	8,000	787	21,637
Trust preferred capital notes	-	-	20,619	-	20,619

Total interest sensitive liabilities	473,314	54,873	58,458	787	587,432
Interest sensitivity gap	$ (109,492)	$ 86,845	$ 39,592	$ 118,425	$ 135,370
Cumulative interest sensitivity gap	$ (109,492)	$ (22,647)	$ 16,945	$ 135,370	
Percentage cumulative gap to total interest sensitive assets	(15.1) %	(3.1) %	2.3%	18.7%	

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

Table 6 shows the estimated impact of changes in interest rates on net interest income as of December 31, 2008, assuming gradual and parallel changes in interest rates, and consistent levels of assets and liabilities. Net interest income for the following twelve months is projected to increase when interest rates are higher than current rates. Due to the current low interest rate environment, no measurement was considered necessary for a further decline in interest rates.

Table 6 - Estimated Changes in Net Interest Income
(dollars in thousands)

Change in Interest Rates	December 31, 2008 Changes in Net interest Income (1) Amount	Percent
Up 3.0%	$ 2,460	9.3%
Up 2.0%	2,210	8.3
Up 1.0%	1,443	5.4
Up 0.5%	836	3.2
No change	-	-

(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.

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Management cannot predict future interest rates or their exact effect on net interest income. Computations of future effects of hypothetical interest rate changes are based on numerous assumptions and should not be relied upon as indicative of actual results. Certain limitations are inherent in such computations. Assets and liabilities may react differently than projected to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag changes in market interest rates. Interest rate shifts may not be parallel.

Changes in interest rates can cause substantial changes in the amount of prepayments of loans and mortgage-backed securities, which may in turn affect the Company's interest rate sensitivity position. Additionally, credit risk may rise if an interest rate increase adversely affects the ability of borrowers to service their debt.

Liquidity Risk Management

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

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

The Company has a line of credit with the FHLB, equal to 30% of the Company's assets, subject to the amount of collateral pledged. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB. Borrowings under the line were $21,637,000 at December 31, 2008 and $16,137,000 at December 31, 2007.

The Company had fixed-rate term borrowing contracts with the FHLB as of December 31, 2008, with the following final maturities:

Amount	Expiration Date
$5,000,000	2009
8,000,000	2011
787,000	2014

The Company 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, 2008 or 2007.

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BALANCE SHEET ANALYSIS

Securities

The securities portfolio generates income, plays a primary role in the management of interest rate sensitivity, provides a source of liquidity, and is used to meet collateral requirements. The securities portfolio consists primarily of high quality investments. Federal agency, mortgage-backed, and state and municipal securities comprise the majority of the portfolio.
During 2008, the Company sold all remaining shares it held in FNMA and FHLMC preferred stock.

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

Table 7 - Securities Portfolio
(in thousands, except yields)

	December 31, 2008		2007		2006	
	Amortized Cost	Taxable Equivalent Yield	Amortized Cost	Taxable Equivalent Yield	Amortized Cost	Taxable Equivalent Yield
Federal Agencies:						
Within 1 year	$ 8,240	4.58%	$ 4,000	3.46%	$ 36,969	3.92%
1 to 5 years	29,719	4.95	45,170	4.79	45,432	4.62
5 to 10 years	5,372	5.15	6,180	5.46	6,706	4.67
Over 10 years	-	-	-	-	-	-
Total	43,331	4.91	55,350	4.77	89,107	4.34
Mortgage-backed:						
Within 1 year	746	3.91	108	3.43	-	-
1 to 5 years	3,435	4.95	3,461	4.33	4,460	4.51
5 to 10 years	12,730	4.81	14,411	4.85	8,345	4.83
Over 10 years	28,482	5.08	27,674	5.34	6,805	5.06
Total	45,393	4.97	45,654	5.10	19,610	4.84
State and Municipal:						
Within 1 year	4,549	5.04	4,025	5.60	1,330	6.69
1 to 5 years	23,127	4.99	24,443	4.97	23,036	5.15
5 to 10 years	9,302	5.99	11,679	5.63	16,550	5.16
Over 10 years	6,615	6.19	7,878	5.73	5,179	6.03
Total	43,593	5.39	48,025	5.31	46,095	5.30
Other Securities:						
Within 1 year	1,485	3.32	-	-	1,005	6.06
1 to 5 years	-	-	1,485	3.32	1,485	3.32
5 to 10 years	-	-	-	-	-	-

Over 10 years	3,899	2.35	4,994	6.56	6,401	6.21
Total	5,384	2.62	6,479	5.82	8,891	5.71
Total portfolio	$ 137,701	4.99%	$ 155,508	5.08%	$ 163,703	4.74%

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Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans. Average loans increased $17,623,000, or 3.2%, from 2007 to 2008. Average loans increased $36,283,000, or 7.1%, from 2006 to 2007. The 2007 increase was due largely to the acquisition of Community First, which occurred in April 2006.

Period-end loans increased $19,719,000, or 3.6%, from December 31, 2007 to December 31, 2008. The increase was primarily due to growth in commercial real estate and home equity loans.

Loans held for sale are loans originated and in process of being sold to the secondary market. These loans are sold servicing released and totaled $1,764,000 at December 31, 2008, and $1,368,000 at December 31, 2007.

The following table provides loan balances, percentage of portfolio (excluding loans held for sale), and the percentage change since December 31, 2007 of loans outstanding by geographic region. The loans are allocated to the region in which they were originated. In some circumstances, loans may be originated in one region for borrowers located in other regions.

Table 8 - Loans by Geographic Region

	December 31, 2008		
(dollars in thousands)	Balance	Percentage of Portfolio	Percentage Change in Balance Since December 31, 2007
Danville region	$ 218,292	38.2%	5.9%
Central region	161,933	28.4	7.2
Southside region:			
Martinsville and Henry County	111,788	19.6	3.4
Halifax and Pittsylvania County	61,415	10.7	(2.8)
Greensboro area	17,682	3.1	(23.3)
Total loans	$ 571,110	100.0%	

The Company does not participate in highly leveraged lending transactions, as defined by bank regulations, and there are no loans of this nature recorded in the loan portfolio. The Company has no foreign loans in its portfolio. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2008 or 2007, loans to lessors of nonresidential buildings represented 13.7% of total loans at December 31, 2008 and 11.0% at December 31, 2007; the lessees and lessors are engaged in a variety of industries.

Table 9 illustrates loans by type.

Table 9 - Loans

	December 31,				
(in thousands)	2008	2007	2006	2005	2004
Real estate:					
Construction and land development	$ 63,361	$ 69,803	$ 69,404	$ 50,092	$ 34,101
Commercial real estate	207,160	198,332	186,639	142,968	147,653
Residential real estate	136,480	133,899	131,126	94,405	91,672
Home equity	57,170	48,313	52,531	42,178	42,620
Total real estate	464,171	450,347	439,700	329,643	316,046
Commercial and industrial	98,546	91,028	91,511	76,735	75,847
Consumer	8,393	10,016	11,017	10,709	15,376
Total loans	$ 571,110	$ 551,391	$ 542,228	$ 417,087	$ 407,269

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The following table presents the maturity schedule of selected loan types (in thousands).

Table 10 - Maturities of Selected Loan Types
December 31, 2008

(in thousands)	Commercial and Industrial (1)	Real Estate Construction	Total
1 year or less	$ 63,928	$ 42,949	$ 106,877
1 to 5 years (2)	29,994	14,838	44,832
After 5 years (2)	4,624	5,574	10,198
Total	$ 98,546	$ 63,361	$ 161,907

(1) includes agricultural loans.
(2) Of the loans due after one year, $48,578 have predetermined interest rates and $6,452 have floating or adjustable interest rates.

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

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

Calculations of the allowance for loan losses are prepared quarterly by the Loan Review department. The calculations are reviewed for adequacy each quarter by the Company's Credit Committee, Audit and Compliance Committee, and Board of Directors. In determining the adequacy of the allowance for loan losses, factors which are considered include the Company's historical loss experience; the size and composition of the loan portfolio; loan risk ratings; nonperforming loans; impaired loans; other problem credits; the value and adequacy of collateral and guarantors; and national and local economic conditions.

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

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

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period. Furthermore, management cannot provide assurance that, in any particular period, the Company will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time, including economic conditions, industry trends, and ongoing internal and external examination processes. The allowance is subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance in comparison to peer banks.

The Southern Virginia market, in which the Company has a significant presence, is under economic pressure. The region's economic base has historically been weighted toward the manufacturing sector. Increased global competition has negatively impacted the textile industry and several manufacturers have closed plants due to competitive pressures or the relocation of some operations to foreign countries. Other important industries include farming, tobacco processing and sales, food processing, furniture manufacturing and sales, specialty glass manufacturing, and packaging tape production. Companies within these industries, especially furniture manufacturing, have also closed plants for reasons similar to those noted above. Additional declines in manufacturing production and unemployment could negatively impact the ability of certain borrowers to repay loans. Also, the current economic and credit crisis, which is resulting in rising unemployment and increasing bankruptcies, foreclosures and bank failures nationally, may further intensify the economic pressure in our markets.

The allowance for loan losses was $7,824,000 at December 31, 2008, compared with $7,395,000 and $7,264,000 at December 31, 2007 and 2006, respectively. The allowance for loan losses as a percentage of loans at each of these dates was 1.37%, 1.34%, and 1.34%, respectively. The provision for loan losses was $1,620,000 in 2008, $403,000 in 2007, and $58,000 in 2006.

Loans charged-off net of recoveries totaled $1,191,000 in 2008, $272,000 in 2007, and $501,000 in 2006. One residential construction and development loan, secured by undeveloped and partially-developed land in the Triad area of North Carolina, accounted for $575,000 of the net charge-offs in 2008. Table 14 presents the Company's loan loss and recovery experience for the past five years.

The allowance for loan losses is allocated to loan types based upon historical loss factors; risk grades on individual loans; portfolio analyses of smaller balance, homogenous loans; and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers and other lending staff; national and local economic trends and conditions; and concentrations of credit. Table 12 summarizes the allocation of the allowance for loan losses for the past five years.

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

Table 11 - Impaired Loans

	December 31,				
(in thousands)	2008	2007	2006	2005	2004
Not on nonaccrual status	$ 1,921	$ 2,255	$ 262	$ 537	$ 1,007
On nonaccrual status	1,271	1,310	1,114	2,995	5,303
Total impaired loans	$ 3,192	$ 3,565	$ 1,376	$ 3,532	$ 6,310

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

	December 31,									
	2008		2007		2006		2005		2004	
	$	% (1)	$	% (1)	$	% (1)	$	% (1)	$	% (1)
Commercial (including commercial real estate)	$ 5,163	62%	$ 5,056	62%	$ 4,467	61%	$ 3,897	64%	$ 5,927	61%
Residential real estate	2,335	37	1,852	36	2,119	37	1,462	33	1,231	35
Consumer	326	1	443	2	521	2	653	3	816	4
Unallocated	-	-	44	-	157	-	97	-	8	-
Total	$ 7,824	100%	$ 7,395	100%	$ 7,264	100%	$ 6,109	100%	$ 7,982	100%

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

Table 13 - Asset Quality Ratios

	As of or for the Years Ended December 31,				
	2008	2007	2006	2005	2004
Allowance to loans*	1.37%	1.34%	1.34%	1.46%	1.96%
Net charge-offs to year-end allowance	15.23	3.68	6.90	38.27	5.07
Net charge-offs to average loans	0.21	0.05	0.10	0.56	0.10
Nonperforming assets to total assets*	0.91	0.42	0.45	0.72	1.35
Nonperforming loans to loans*	0.50	0.48	0.63	1.02	1.99
Provision to net charge-offs	136.02	148.16	11.58	19.89	764.20
Provision to average loans	0.29	0.07	0.01	0.11	0.77
Allowance to nonperforming	275.01	280.22	212.09	142.97	98.39

loans*

* - at year end

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

	Year Ended December 31, 2008	2007	2006	2005	2004
Balance at beginning of period	$ 7,395	$ 7,264	$ 6,109	$ 7,982	$ 5,292
Allowance from acquisition	-	-	1,598	-	-
Charge-offs:					
Construction and land development	1,007	-	1	-	-
Commercial real estate	61	54	136	2,249	-
Residential real estate	196	140	163	35	85
Home equity	62	19	-	-	44
Total real estate	1,326	213	300	2,284	129
Commercial and industrial	63	103	354	76	169
Consumer	175	199	259	217	357
Total charge-offs	1,564	515	913	2,577	655
Recoveries:					
Construction and land development	71	-	1	-	-
Commercial real estate	101	15	98	46	49
Residential real estate	3	3	11	3	-
Home equity	-	1	1	-	-
Total real estate	175	19	111	49	49
Commercial and industrial	18	50	108	11	45
Consumer	180	174	193	179	156
Total recoveries	373	243	412	239	250
Net charge-offs	1,191	272	501	2,338	405
Provision for loan losses	1,620	403	58	465	3,095
Balance at end of period	$ 7,824	$ 7,395	$ 7,264	$ 6,109	$ 7,982

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and any loans classified as troubled debt restructurings. Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming loans represented 0.91% of total loans at December 31, 2008, up from 0.48% at December 31, 2007. There were no troubled debt restructurings at the end of any of the years presented in the table.

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Table 15 - Nonperforming Assets
(in thousands)

	December 31,				
	2008	2007	2006	2005	2004
Nonaccrual loans:					
Real estate	$ 2,730	$ 2,488	$ 3,195	$ 4,098	$ 7,005
Commercial	73	107	151	12	853
Agricultural	-	-	-	-	12
Consumer	42	44	79	107	243
Total nonaccrual loans	2,845	2,639	3,425	4,217	8,113
Restructured loans	-	-	-	-	-
Loans past due 90 days and accruing interest:					
Real estate	-	-	-	46	-
Commercial	-	-	-	10	-
Agricultural	-	-	-	-	-
Consumer	-	-	-	-	-
Total past due loans	-	-	-	56	-
Total nonperforming loans	2,845	2,639	3,425	4,273	8,113
Foreclosed real estate	4,311	632	99	188	221
Total nonperforming assets	$ 7,156	$ 3,271	$ 3,524	$ 4,461	$ 8,334

Deposits

The Company’s deposits consist primarily of checking, money market, savings, and consumer time deposits. Average deposits decreased 8,511,000, or 1.4%, in 2008 after increasing $1,350,000, or 0.2%, in 2007. Period-end deposits increased $ $7,917,000, or 1.4%, from December 31, 2007 to December 31, 2008. The increase in period-end deposits is attributed primarily to a special interest bearing demand deposit rate arrangement with a municipality.

During 2008, demand deposits increased $7,853,000, or 3.9%, money market deposits increased $6,361,000, or 12.7%, while savings deposits declined $2,776,000, or 4.5% and certificates of deposit declined $3,521,000, or 1.3%, as customers sought higher-yielding accounts.

Table 16 - Deposits
(in thousands, except rates)

	December 31,					
	2008		2007		2006	
	Average Balance	Rate	Average Balance	Rate	Average Balance	Average Rate
Demand deposits - noninterest bearing	$ 98,157	-%	$ 102,003	-%	$ 102,117	-%
Demand deposits - interest bearing	109,492	0.73	107,834	1.44	105,320	1.44
Money market	53,659	1.88	52,843	2.70	48,124	2.45
Savings	61,620	0.54	66,246	1.28	77,445	1.24
Time	258,773	3.92	261,286	4.48	255,856	3.79
	$ 581,701	2.11%	$ 590,212	2.63%	$ 588,862	2.27%

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

Certificates of deposit at December 31, 2008 in amounts of $100,000 or more were classified by maturity as follows:

3 months or less	$	19,666
Over 3 through 6 months		25,405
Over 6 through 12 months		19,086
Over 12 months		43,029
	$	107,186

Borrowed Funds

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

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

Table 18 - Short-Term Borrowings
(dollars in thousands)

	December 31, 2008		December 31, 2007	
Customer repurchase agreements	$	51,741	$	47,891
FHLB overnight borrowings		7,850		7,200
Total	$	59,591	$	55,091
Weighted interest rate		1.75%		3.78%
Average for the year ended:				
Outstanding	$	62,082	$	48,435
Interest rate		2.62%		3.84%
Maximum month-end outstanding	$	81,598	$	55,091

Shareholders' Equity

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

Shareholders’ equity was $102,300,000 at December 31, 2008 and $101,511,000 at December 31, 2007. This increase was largely the result of net income but was partially offset by dividends, stock repurchases and the effect of changes in unfunded pension liability.

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

The Company declared and paid quarterly dividends totaling $0.92, $0.91, and $0.87 per share of common stock in 2008, 2007, and 2006, respectively. Cash dividends in 2008 totaled $5,606,000 and represented a 69.9% payout of 2008 net income, compared to 48.8% in 2007 and 45.6% in 2006.

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One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Shareholders' equity was 12.96% of assets at December 31, 2008 and 13.14% at December 31, 2007. In addition to this measurement, banking regulators have defined minimum regulatory capital ratios that the Company and its banking subsidiary are required to maintain. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and off-balance sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance sheet assets in relation to their perceived risk. Under the guidelines, capital strength is measured in two tiers. Tier I capital consists primarily of shareholder's equity and trust preferred capital notes, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the total of Tier I and Tier II capital. Another regulatory indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier I capital by average quarterly assets less intangible assets.

The regulatory guidelines require that minimum total capital (Tier I plus Tier II) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier I capital. At December 31, 2008, the Company's Tier I and total capital ratios were 16.67% and 17.92%, respectively. At December 31, 2007, these ratios were 17.03% and 18.28%, respectively. The ratios for both years exceeded the regulatory requirements. The Company's leverage ratios were 13.04% and 12.98% at December 31, 2008 and 2007, 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, 2008 and 2007, that the Company met the requirements to be considered "well capitalized."

CONTRACTUAL OBLIGATIONS

The following items are contractual obligations of the Company as of December 31, 2008 (in thousands):

	Payments Due By Period				
	Total	Under 1 Year	1-3 Years	3-5 Years	More than 5 years
Time deposits	$ 261,064	$ 181,352			