

AMERICAN NATIONAL BANKSHARES INC.  
Form 10-Q  
November 10, 2014

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2014.

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

Commission file number: 0-12820

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

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

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

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

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

YesxNoo

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

YesxNoo

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  (Do not check if a smaller reporting company)  
Smaller reporting company

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

YesoNox

At November 6, 2014, the Company had 7,846,454 shares of Common Stock outstanding, \$1 par value.

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AMERICAN NATIONAL BANKSHARES INC.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## American National Bankshares Inc. and Subsidiaries

## Consolidated Balance Sheets

(Dollars in thousands, except share data)

	(Unaudited) September 30, 2014	(Audited) December 31, 2013
Assets		
Cash and due from banks	\$22,699	\$19,808
Interest-bearing deposits in other banks	58,278	47,873
Securities available for sale, at fair value	328,534	346,124
Restricted stock, at cost	4,529	4,889
Loans held for sale	811	2,760
Loans, net of unearned income	816,588	794,671
Less allowance for loan losses	(12,620)	(12,600)
Net loans	803,968	782,071
Premises and equipment, net	23,085	23,674
Other real estate owned, net	2,364	3,422
Goodwill	39,043	39,043
Core deposit intangibles, net	2,271	3,159
Bank owned life insurance	15,044	14,746
Accrued interest receivable and other assets	18,531	19,943
Total assets	\$1,319,157	\$1,307,512
Liabilities		
Liabilities:		
Demand deposits -- noninterest bearing	\$244,469	\$229,347
Demand deposits -- interest bearing	185,982	167,736
Money market deposits	173,192	185,270
Savings deposits	88,226	85,724
Time deposits	359,191	389,598
Total deposits	1,051,060	1,057,675
Customer repurchase agreements	51,945	39,478
Long-term borrowings	9,930	9,951
Trust preferred capital notes	27,495	27,419
Accrued interest payable and other liabilities	5,562	5,438
Total liabilities	1,145,992	1,139,961
Shareholders' equity		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	-	-
Common stock, \$1 par, 20,000,000 shares authorized, 7,843,454 shares outstanding at September 30, 2014 and 7,890,697 shares outstanding at December 31, 2013	7,843	7,891

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Capital in excess of par value	57,087	58,050
Retained earnings	103,515	99,090
Accumulated other comprehensive income, net	4,720	2,520
Total shareholders' equity	173,165	167,551
Total liabilities and shareholders' equity	\$ 1,319,157	\$ 1,307,512

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

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## American National Bankshares Inc. and Subsidiaries

## Consolidated Statements of Income

(Dollars in thousands, except share and per share data) (Unaudited)

	Three Months Ended September 30,	
	2014	2013
Interest and Dividend Income:		
Interest and fees on loans	\$9,864	\$11,100
Interest and dividends on securities:		
Taxable	918	845
Tax-exempt	966	1,056
Dividends	72	67
Other interest income	32	38
Total interest and dividend income	11,852	13,106
Interest Expense:		
Interest on deposits	1,120	1,338
Interest on short-term borrowings	4	3
Interest on long-term borrowings	82	82
Interest on trust preferred capital notes	186	190
Total interest expense	1,392	1,613
Net Interest Income	10,460	11,493
Provision for Loan Losses	-	-
Net Interest Income After Provision for Loan Losses	10,460	11,493
Noninterest Income:		
Trust fees	992	1,077
Service charges on deposit accounts	441	452
Other fees and commissions	479	471
Mortgage banking income	342	464
Securities gains, net	315	4
Other	412	299
Total noninterest income	2,981	2,767
Noninterest Expense:		
Salaries	3,714	3,610
Employee benefits	799	856
Occupancy and equipment	933	933
FDIC assessment	157	163
Bank franchise tax	216	187
Core deposit intangible amortization	227	330
Data processing	361	305
Software	248	198
Foreclosed real estate, net	141	245
Merger related expense	268	-
Other	1,763	1,628

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Total noninterest expense	8,827	8,455
Income Before Income Taxes	4,614	5,805
Income Taxes	1,446	1,562
Net Income	\$3,168	\$4,243
Net Income Per Common Share:		
Basic	\$0.40	\$0.54
Diluted	\$0.40	\$0.54
Average Common Shares Outstanding:		
Basic	7,841,078	7,877,901
Diluted	7,851,735	7,892,015

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



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## American National Bankshares Inc. and Subsidiaries

## Consolidated Statements of Income

(Dollars in thousands, except share and per share data) (Unaudited)

	Nine Months Ended September 30	
	2014	2013
Interest and Dividend Income:		
Interest and fees on loans	\$29,398	\$33,853
Interest and dividends on securities:		
Taxable	2,850	2,574
Tax-exempt	3,017	3,153
Dividends	221	176
Other interest income	100	106
Total interest and dividend income	35,586	39,862
Interest Expense:		
Interest on deposits	3,510	4,143
Interest on short-term borrowings	8	38
Interest on long-term borrowings	243	246
Interest on trust preferred capital notes	555	567
Total interest expense	4,316	4,994
Net Interest Income	31,270	34,868
Provision for Loan Losses	150	294
Net Interest Income After Provision for Loan Losses	31,120	34,574
Noninterest Income:		
Trust fees	3,131	2,609
Service charges on deposit accounts	1,285	1,290
Other fees and commissions	1,416	1,393
Mortgage banking income	880	1,713
Securities gains, net	504	203
Other	1,168	1,015
Total noninterest income	8,384	8,223
Noninterest Expense:		
Salaries	10,890	10,552
Employee benefits	2,621	2,622
Occupancy and equipment	2,779	2,721
FDIC assessment	486	485
Bank franchise tax	669	559
Core deposit intangible amortization	888	1,171
Data processing	1,054	892
Software	745	659
Foreclosed real estate, net	148	681
Merger related expense	268	-
Other	5,067	4,859
Total noninterest expense	25,615	25,201

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Income Before Income Taxes	13,889	17,596
Income Taxes	4,038	4,992
Net Income	\$9,851	\$12,604
Net Income Per Common Share:		
Basic	\$1.25	\$1.60
Diluted	\$1.25	\$1.60
Average Common Shares Outstanding:		
Basic	7,871,016	7,867,835
Diluted	7,881,441	7,878,961

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

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

	Three Months Ended September 30, 2014 2013	
Net income	\$3,168	\$4,243
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	(343 )	193
Income tax (expense) benefit	121	(67 )
Reclassification adjustment for gains on securities	(315 )	(4 )
Income tax expense	110	1
Other comprehensive income (loss)	(427 )	123
Comprehensive income	\$2,741	\$4,366
	Nine Months Ended September 30, 2014 2013	
Net income	\$9,851	\$12,604
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	3,888	(7,988 )
Income tax (expense) benefit	(1,360 )	2,796
Reclassification adjustment for gains on securities	(504 )	(203 )
Income tax expense	176	71
Other comprehensive income (loss)	2,200	(5,324 )
Comprehensive income	\$12,051	\$7,280

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



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American National Bankshares Inc. and Subsidiaries  
 Consolidated Statements of Changes in Shareholders' Equity  
 Nine Months Ended September 30, 2014 and 2013  
 (Dollars in thousands except per share data) (Unaudited)

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2012	\$ 7,847	\$57,211	\$90,591	\$ 7,597	\$ 163,246
Net income	-	-	12,604	-	12,604
Other comprehensive loss	-	-	-	(5,324 )	(5,324 )
Stock options exercised	17	292	-	-	309
Equity based compensation	22	402	-	-	424
Cash dividends declared, \$0.69 per share	-	-	(5,433 )	-	(5,433 )
Balance, September 30, 2013	\$ 7,886	\$57,905	\$97,762	\$ 2,273	\$ 165,826
Balance, December 31, 2013	\$ 7,891	\$58,050	\$99,090	\$ 2,520	\$ 167,551
Net income	-	-	9,851	-	9,851
Other comprehensive income	-	-	-	2,200	2,200
Stock repurchased and retired	(70 )	(1,438 )	-	-	(1,508 )
Equity based compensation	22	475	-	-	497
Cash dividends declared, \$0.69 per share	-	-	(5,426 )	-	(5,426 )
Balance, September 30, 2014	\$ 7,843	\$57,087	\$103,515	\$ 4,720	\$ 173,165

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

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American National Bankshares Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Nine Months Ended September 30, 2014 and 2013  
(Dollars in thousands) (Unaudited)

	2014	2013
Cash Flows from Operating Activities:		
Net income	\$9,851	\$12,604
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	150	294
Depreciation	1,274	1,284
Net accretion of acquisition accounting adjustments	(2,064 )	(5,809 )
Core deposit intangible amortization	888	1,171
Net amortization of securities	1,916	2,430
Net gain on sale or call of securities	(504 )	(203 )
Gain on sale of loans held for sale	(686 )	(1,466 )
Proceeds from sales of loans held for sale	40,813	78,936
Originations of loans held for sale	(38,178)	(67,537)
Net gain on foreclosed real estate	(100 )	(86 )
Valuation allowance on foreclosed real estate	46	327
Equity based compensation expense	497	424
Deferred income tax expense (benefit)	396	(1,388 )
Net change in interest receivable	(916 )	107
Net change in other assets	450	2,529
Net change in interest payable	(29 )	(100 )
Net change in other liabilities	153	537
Net cash provided by operating activities	13,957	24,054
Cash Flows from Investing Activities:		
Proceeds from sales of securities available for sale	13,667	2,627
Proceeds from maturities, calls and paydowns of securities available for sale	52,901	41,961
Purchases of securities available for sale	(47,006)	(67,378)
Net change in restricted stock	360	402
Net increase in loans	(20,276)	(5,943 )
Purchases of premises and equipment	(685 )	(723 )
Proceeds from sales of foreclosed real estate	1,498	3,286
Net cash provided by (used in) investing activities	459	(25,768)
Cash Flows from Financing Activities:		
Net change in demand, money market, and savings deposits	23,792	50,700
Net change in time deposits	(30,407)	(7,006 )
Net change in customer repurchase agreements	12,467	(5,916 )
Net change in long-term borrowings	(38 )	(113 )
Common stock dividends paid	(5,426 )	(5,433 )
Repurchase of stock	(1,508 )	-
Proceeds from exercise of stock options	-	309
Net cash (used in) provided by financing activities	(1,120 )	32,541

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Net Increase in Cash and Cash Equivalents	13,296	30,827
Cash and Cash Equivalents at Beginning of Period	67,681	47,442
Cash and Cash Equivalents at End of Period	\$80,977	\$78,269

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

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

Note 1 – Basis of Presentation

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

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

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

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

Note 2 – Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2014-01, "Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company is currently assessing the impact that ASU 2014-01 will have on its consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, "Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a



consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements. In April 2014, the FASB issued ASU 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." The amendments in this ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results and include disposals of a major geographic area, a major line of business, or a major equity method investment. The new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. Additionally, the new guidance requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in the ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-08 to have a material impact on its consolidated financial statements.

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In June 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606". This ASU applies to any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the revenue recognition requirements in Topic 605, "Revenue Recognition", most industry-specific guidance, and some cost guidance included in Subtopic 605-35, "Revenue Recognition—Construction-Type and Production-Type Contracts". The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2014-09 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU 2014-10, "Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation". The amendments in this ASU remove all incremental financial reporting requirements from U.S. GAAP for development stage entities, including the removal of Topic 915, "Development Stage Entities", from the FASB Accounting Standards Codification. In addition, this ASU adds an example disclosure and removes an exception provided to development stage entities in Topic 810, "Consolidation", for determining whether an entity is a variable interest entity. The presentation and disclosure requirements in Topic 915 will no longer be required for the first annual period beginning after December 15, 2014. The revised consolidation standards are effective for annual periods beginning after December 15, 2015. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-10 to have a material impact on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures". This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2014-11 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-12, "Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period". The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in "Compensation – Stock Compensation (Topic 718)", should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective

or retrospective basis. The Company is currently assessing the impact that ASU 2014-12 will have on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-14, "Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure". The amendments in this ASU apply to creditors that hold government-guaranteed mortgage loans and is intended to eliminate the diversity in practice related to the classification of these guaranteed loans upon foreclosure. The new guidance stipulates that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if (1) the loan has a government guarantee that is not separable from the loan prior to foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the other receivable should be measured on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2014. Entities may adopt the amendments on a prospective basis or modified retrospective basis as of the beginning of the annual period of adoption; however, the entity must apply the same method of transition as elected under ASU 2014-04. Early adoption is permitted provided the entity has already adopted ASU 2014-04. The Company is currently assessing the impact that ASU 2014-14 will have on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern". This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have a material impact on its consolidated financial statements.

### Note 3 – Securities

The amortized cost and estimated fair value of investments in debt and equity securities at September 30, 2014 and December 31, 2013 were as follows:

(in thousands)	September 30, 2014			Estimated Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Securities available for sale:				
Federal agencies and GSEs	\$69,911	\$ 177	\$ 145	\$69,943
Mortgage-backed and CMOs	59,916	1,197	241	60,872
State and municipal	180,340	7,985	128	188,197
Corporate	8,478	13	82	8,409
Equity securities	1,000	113	-	1,113
Total securities available for sale	\$319,645	\$ 9,485	\$ 596	\$328,534

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

## Restricted Stock

Due to restrictions placed upon the Bank's common stock investment in the Federal Reserve Bank of Richmond ("FRB") and Federal Home Loan Bank of Atlanta ("FHLB"), these securities have been classified as restricted equity securities and carried at cost. The restricted securities are not subject to the investment security classification and are included as a separate line item on the Company's balance sheet. The FRB requires the Bank to maintain stock with a par value equal to 6.0% of its common stock and paid-in surplus. One-half of this amount is paid to the Federal Reserve Bank and the remaining half is subject to call when deemed necessary by the Board of Governors of the Federal Reserve System. The FHLB requires the Bank to maintain stock in an amount equal to a specific percentage of the Bank's total assets and 4.5% of outstanding borrowings. The Bank also owns common stock in CBB Financial Corporation, a Community Bankers Bank located in Richmond, Virginia which provides services to community banks that was inherited from the merger with Community First Financial Corporation in 2006 and common stock in Danville Community Development Corporation, a corporation formed by local banks in the Danville, Virginia area that restores dilapidated properties for resale. The cost of restricted stock at September 30, 2014 and December 31, 2013 were as follows:

(in thousands)	September 30, 2014	December 31, 2013
FRB stock	\$ 1,625	\$ 2,722
FHLB stock	2,737	2,000
CBB Financial Corporation stock	101	101
Danville Community Development Corporation stock	66	66
Total restricted stock	\$ 4,529	\$ 4,889

## Temporarily Impaired Securities

The following table shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2014. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period.

(in thousands)	Total Estimated		Less than 12 Months Estimated		12 Months or More Estimated	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	\$30,126	\$ 145	\$10,613	\$ 30	\$19,513	\$ 115

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Mortgage-backed and CMOs	14,362	241	8,315	28	6,047	213
State and municipal	14,539	128	8,217	66	6,322	62
Corporate	5,039	82	2,285	11	2,754	71
Total	\$64,066	\$ 596	\$29,430	\$ 135	\$34,636	\$ 461

GSE debt securities: The unrealized losses on the Company's investment in 14 government sponsored entities ("GSE") were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2014.

Mortgage-backed securities and CMOs: The unrealized losses on the Company's investment in 14 GSE mortgage-backed securities and collateralized mortgage obligations ("CMOs") were caused by interest rate increases. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2014.

State and municipal securities: The unrealized losses on 15 state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2014.

Corporate securities: The unrealized losses on five investments in corporate securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2014.

Restricted stock: When evaluating restricted stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The company does not consider restricted stock to be other-than-temporarily impaired at September 30, 2014, and no impairment has been recognized.

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

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

Other-Than-Temporary-Impaired Securities

As of September 30, 2014 and December 31, 2013, there were no securities classified as having other-than-temporary impairment.

Note 4 - LoansSegments

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

(in thousands)	September 30, 2014	December 31, 2013
Commercial	\$ 126,437	\$ 122,553
Commercial real estate:		
Construction and land development	47,060	41,822
Commercial real estate	371,743	364,616
Residential real estate:		
Residential	175,091	171,917
Home equity	90,952	87,797
Consumer	5,305	5,966
Total loans	\$ 816,588	\$ 794,671

Acquired Loans

Interest income, including accretion, on loans acquired from MidCarolina Financial Corporation ("MidCarolina") in connection with the Company's acquisition of MidCarolina for the nine months ended September 30, 2014 was approximately \$8.5 million. This included \$2.2 million in accretion income of which \$88,000 was related to loan payoffs and renewals and \$290,000 related to recoveries of loans charged off prior to the merger. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheets at September 30, 2014 and December 31, 2013 are as follows:

(in thousands)	September 30, 2014	December 31, 2013
Outstanding principal balance	\$ 92,092	\$ 134,099

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Carrying amount	84,711	124,828
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The outstanding principal balance and related carrying amount of acquired impaired loans, for which the Company applies Accounting Standards Codification ("ASC") 310-30, to account for interest earned, at September 30, 2014 and December 31, 2013 are as follows:

(in thousands)	September 30, 2014	December 31, 2013
Outstanding principal balance	\$ 18,780	\$ 21,014
Carrying amount	14,847	16,644

The following table presents changes in the accretable discount on acquired impaired loans, for which the Company applies ASC 310-30, for the nine months ended September 30, 2014. The accretion reflected below includes \$88,000 related to loan payoffs.

(in thousands)	Accretable Discount
Balance at December 31, 2013	\$ 2,046
Accretion	(862 )
Reclassification from nonaccretable difference	443
Balance at September 30, 2014	\$ 1,627

IndexPast Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at September 30, 2014.

(in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing	Non-Accrual Loans	Total Past Due	Current	Total Loans
Commercial	\$-	\$ -	\$ -	\$ 2	\$ 2	\$126,435	\$126,437
Commercial real estate:							
Construction and land development	-	-	-	290	290	46,770	47,060
Commercial real estate	-	-	-	3,399	3,399	368,344	371,743
Residential:							
Residential	389	6	-	590	985	174,106	175,091
Home equity	205	-	-	211	416	90,536	90,952
Consumer	2	-	-	2	4	5,301	5,305
Total	\$ 596	\$ 6	\$ -	\$ 4,494	\$ 5,096	\$811,492	\$816,588

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

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



IndexImpaired Loans

The following table presents the Company's impaired loan balances by portfolio segment, excluding loans acquired with deteriorated credit quality, at September 30, 2014.

(in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 9	\$ 9	\$ -	\$ 14	\$ 1
Commercial real estate:					
Construction and land development	291	333	-	504	-
Commercial real estate	984	990	-	919	-
Residential:					
Residential	511	523	-	768	-
Home equity	205	205	-	350	-
Consumer	2	2	-	3	-
	\$ 2,002	\$ 2,062	\$ -	\$ 2,558	\$ 1
With a related allowance recorded:					
Commercial	-	-	-	-	-
Commercial real estate:					
Construction and land development	582	582	11	597	25
Commercial real estate	2,202	2,229	631	2,219	13
Residential:					
Residential	4	4	1	4	-
Home equity	-	-	-	-	-
Consumer	16	16	3	17	1
	\$ 2,804	\$ 2,831	\$ 646	\$ 2,837	\$ 39
Total:					
Commercial	\$ 9	\$ 9	\$ -	\$ 14	\$ 1
Commercial real estate:					
Construction and land development	873	915	11	1,101	25
Commercial real estate	3,186	3,219	631	3,138	13
Residential:					
Residential	515	527	1	772	-
Home equity	205	205	-	350	-
Consumer	18	18	3	20	1
	\$ 4,806	\$ 4,893	\$ 646	\$ 5,395	\$ 40

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

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

The following table shows the detail of loans modified as troubled debt restructurings ("TDRs") during the nine months ended September 30, 2014 included in the impaired loan balances. There were no loans modified as TDRs for the three months ended September 30, 2014 and 2013 or the nine months ended September 30, 2013.

(dollars in thousands)	Loans Modified as a TDR for the Nine Months Ended September 30, 2014	
	Pre-Modification Number of Recorded Contra-	Post-Modification Outstanding Recorded Investment
	Investment	Investment

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Commercial	-	\$ -	\$ -
Commercial real estate	1	182	179
Construction and land development	-	-	-
Home Equity	1	8	8
Residential real estate	2	121	115
Consumer	-	-	-
Total	4	\$ 311	\$ 302

During the three and nine months ended September 30, 2014 and 2013, the Company had no loans that subsequently defaulted within twelve months of modification.

IndexRisk Grades

The following table shows the Company's loan portfolio broken down by internal risk grading as of September 30, 2014.

(in thousands)

Commercial and Consumer Credit Exposure  
Credit Risk Profile by Internally Assigned Grade

	Commercial	Commercial Real Estate Construction	Commercial Real Estate Other	Residential	Home Equity
Pass	\$ 124,768	\$ 41,573	\$ 361,955	\$ 164,460	\$ 88,773
Special Mention	1,659	624	5,400	7,484	1,624
Substandard	10	4,863	4,388	3,147	555
Doubtful	-	-	-	-	-
Total	\$ 126,437	\$ 47,060	\$ 371,743	\$ 175,091	\$ 90,952

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

	Consumer
Performing	\$ 5,303
Nonperforming	2
Total	\$ 5,305

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

(in thousands)

Commercial and Consumer Credit Exposure  
Credit Risk Profile by Internally Assigned Grade

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

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

	Consumer
Performing	\$ 5,966
Nonperforming	-
Total	\$ 5,966

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

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

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

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

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

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

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

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

(in thousands)	Nine Months Ended September 30, 2014	Year Ended December 31, 2013	Nine Months Ended September 30, 2013
<b>Allowance for Loan Losses</b>			
Balance, beginning of period	\$ 12,600	\$ 12,118	\$ 12,118
Provision for loan losses	150	294	294
Charge-offs	(398 )	(837 )	(629 )
Recoveries	268	1,025	901
Balance, end of period	\$ 12,620	\$ 12,600	\$ 12,684
<b>Reserve for Unfunded Lending Commitments</b>			
Balance, beginning of period	\$ 210	\$ 201	\$ 201
Provision for (recovery of) loan losses	(55 )	9	1
Charge-offs	-	-	-
Balance, end of period	\$ 155	\$ 210	\$ 202

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at September 30, 2014.

(in thousands)	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Allowance for Loan Losses						
Balance as of December 31, 2013	\$ 1,810	\$ 6,819	\$ 3,690	\$ 99	\$ 182	\$ 12,600
Charge-offs	(101 )	-	(240 )	(57 )	-	(398 )
Recoveries	42	51	113	62	-	268
Provision for loan losses	70	139	156	(33 )	(182 )	150
Balance as of September 30, 2014	\$ 1,821	\$ 7,009	\$ 3,719	\$ 71	\$ -	\$ 12,620

Balance as of September 30, 2014:

<b>Allowance for Loan Losses</b>						
Individually evaluated for impairment	\$ -	\$ 642	\$ 1	\$ 3	\$ -	\$ 646
Collectively evaluated for impairment	1,818	6,118	3,495	68	-	11,499
Loans acquired with deteriorated credit quality	3	249	223	-	-	475
Total	\$ 1,821	\$ 7,009	\$ 3,719	\$ 71	\$ -	\$ 12,620

Loans

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Individually evaluated for impairment	\$ 9	\$ 4,059	\$ 720	\$ 18	\$ -	\$ 4,806
Collectively evaluated for impairment	126,386	405,601	259,661	5,287	-	796,935
Loans acquired with deteriorated credit quality	42	9,143	5,662	-	-	14,847
Total	\$ 126,437	\$ 418,803	\$ 266,043	\$ 5,305	\$ -	\$ 816,588

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at December 31, 2013.

(in thousands)	Commercial	Residential		Consumer	Unallocated	Total
		Commercial Real Estate	Real Estate			
Allowance for Loan Losses						
Balance as of December 31, 2012	\$ 1,450	\$ 6,822	\$ 3,638	\$ 208	\$ -	\$ 12,118
Charge-offs	(129 )	(164 )	(369 )	(175 )	-	(837 )
Recoveries	335	323	244	123	-	1,025
Provision for loan losses	154	(162 )	177	(57 )	182	294
Balance as of December 31, 2013	\$ 1,810	\$ 6,819	\$ 3,690	\$ 99	\$ 182	\$ 12,600

Balance as of December 31, 2013:

Allowance for Loan Losses						
Individually evaluated for impairment	\$ -	\$ 556	\$ -	\$ 3	\$ -	\$ 559
Collectively evaluated for impairment	1,810	6,039	3,483	96	182	11,610
Loans acquired with deteriorated credit quality	-	224	207	-	-	431
Total	\$ 1,810	\$ 6,819	\$ 3,690	\$ 99	\$ 182	\$ 12,600
Loans						
Individually evaluated for impairment	\$ 19	\$ 4,688	\$ 1,304	\$ 18	\$ -	\$ 6,029
Collectively evaluated for impairment	122,424	392,720	250,906	5,948	-	771,998
Loans acquired with deteriorated credit quality	110	9,030	7,504	-	-	16,644
Total	\$ 122,553	\$ 406,438	\$ 259,714	\$ 5,966	\$ -	\$ 794,671

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The allowance for loan losses is allocated to loan segments based upon historical loss factors, risk grades on individual loans, portfolio analyses of smaller balance, homogenous loans, and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers and other lending staff; national, regional, and local economic trends and conditions; legal, regulatory and collateral factors; and concentrations of credit.

## Note 6 – Goodwill and Other Intangible Assets

The Company records as goodwill the excess of the purchase price over the fair value of the identifiable net assets acquired. Impairment testing is performed annually, as well as when an event triggering impairment may have occurred. The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified as of June 30, 2014.

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

The changes in the carrying amount of goodwill and intangibles for the nine months ended September 30, 2014, are as follows (in thousands):

	Goodwill	Intangibles
Balance as of December 31, 2013	\$ 39,043	\$ 3,159
Additions	-	-
Amortization	-	(888 )
Impairment	-	-
Balance as of September 30, 2014	\$ 39,043	\$ 2,271

## Note 7 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies or GSEs. They mature daily. The interest rates may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. Other short-term borrowings consist of overnight advances which contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted of the following at September 30, 2014 and December 31, 2013 (in thousands):

	September 30, 2014	December 31, 2013
Customer repurchase agreements	\$ 51,945	\$ 39,478
	\$ 51,945	\$ 39,478

## Note 8 – Long-term Borrowings



Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans, home equity lines of credit, and commercial real estate loans. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of September 30, 2014, \$395,857,000 in eligible collateral was pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long-term advances as of September 30, 2014 and December 31, 2013 (dollars in thousands):

September 30, 2014			December 31, 2013		
Due by	Advance Amount	Weighted Average Rate	Due by	Advance Amount	Weighted Average Rate
			March 2014	\$ 38	3.78 %
November 2017	\$ 9,930	2.98	% November 2017	9,913	2.98
	\$ 9,930	2.98		\$ 9,951	3.01 %

The advance due in November 2017 is net of a valuation allowance of \$70,000. The original valuation allowance recorded on July 1, 2011, was a result of the merger with MidCarolina. The adjustment to the face value will be amortized into interest expense over the life of the borrowing.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At September 30, 2014, the Bank's public deposits totaled \$126,973,000. The Company is required to provide collateral to secure the deposits that exceed the insurance coverage provided by the Federal Deposit Insurance Corporation. This collateral can be provided in the form of certain types of government or agency bonds or letters of credit from the FHLB. At September 30, 2014, the Company had \$72,000,000 in letters of credit with the FHLB outstanding, as well as \$111,237,000 in agency, state, and municipal securities to provide collateral for such deposits.

#### Note 9 – Trust Preferred Capital Notes

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

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

On July 1, 2011, in connection with the MidCarolina merger, the Company assumed \$8,764,000 in junior subordinated debentures to MidCarolina Trust I and MidCarolina Trust II, two separate Delaware statutory trusts (the "MidCarolina Trusts"), to fully and unconditionally guarantee the preferred securities issued by the MidCarolina Trusts. These long-term obligations, which currently qualify as Tier 1 capital, constitute a full and unconditional guarantee by the Company of the MidCarolina Trusts' obligations. The MidCarolina Trusts are not consolidated in the Company's financial statements.

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

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

Issuing Entity	Date Issued	Interest Rate	Maturity Date	(Amounts in thousands)	
				Principal Amount September 30, 2014	December 31, 2013
AMNB Trust I	04-07-06	Libor plus 1.35 %	06-30-36	\$ 20,619	\$ 20,619
MidCarolina Trust I	10-29-02	Libor plus 3.45 %	11-07-32	4,140	4,098
MidCarolina Trust II	12-03-03	Libor plus 2.95 %	10-07-33	2,736	2,702
				\$27,495	\$ 27,419

The principal amounts reflected for the MidCarolina Trusts are net of valuation allowances of \$1,015,000 and \$872,000, respectively. The original valuation allowances of \$1,197,000 and \$1,021,000 were recorded as a result of the merger with MidCarolina on July 1, 2011, and are being amortized into interest expense over the remaining lives of the respective borrowings.

Note 10 – Stock Based Compensation

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

### Stock Options

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

A summary of stock option transactions for the nine months ended September 30, 2014 is as follows:

	Option Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (\$000)
Outstanding at December 31, 2013	176,747	\$ 24.39		
Granted	-	-		
Exercised	-	-		
Forfeited	-	-		
Expired	-	-		
			2.58	
Outstanding at September 30, 2014	176,747	\$ 24.39	years	\$ 238
			2.58	
Exercisable at September 30, 2014	176,747	\$ 24.39	years	\$ 238

The fair value of options is estimated at the date of grant using the Black-Scholes option pricing model and expensed over the options' vesting period. As of September 30, 2014, there was no unrecognized compensation expenses related to nonvested stock option grants.

### Restricted Stock

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

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Nonvested restricted stock activity for the nine months ended September 30, 2014 is summarized in the following table.

Restricted Stock	Shares	Weighted Average Grant Date Value
Nonvested at January 1, 2014	33,350	\$ 19.77
Granted	12,702	24.23
Vested	5,602	18.39
Forfeited	-	-
Nonvested at September 30, 2014	40,450	\$ 21.36

As of September 30, 2014 and December 31, 2013, there was \$377,000 and \$337,000 in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. The weighted average period over which this cost is expected to be recognized is 1.27 years. The share based compensation expense for nonvested restricted stock was \$267,000 and \$211,000 during the first nine months of 2014 and 2013, respectively.

Starting in 2010, the Company began offering its outside directors alternatives with respect to director compensation. The regular quarterly board retainer can be received in the form of either (i) \$3,000 in cash or (ii) shares of immediately vested, but restricted stock with a market value of \$4,688. Monthly meeting fees can also be received as \$600 per meeting in cash or \$750 in immediately vested, but restricted stock. For 2014, all 13 outside directors have elected to receive stock in lieu of cash for either all or part of their quarterly retainer or meeting fees. Only outside directors receive board fees. The Company issued 10,239 and 7,217 shares and recognized share based compensation expense of \$230,000 and \$213,000 during the first nine months of 2014 and 2013, respectively.

## Note 11 – Earnings Per Share

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

	Three Months Ended September 30,			
	2014		2013	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	7,841,078	\$ 0.40	7,877,901	\$ 0.54
Effect of dilutive securities - stock options	10,657	-	14,114	-
Diluted	7,851,735	\$ 0.40	7,892,015	\$ 0.54

  

	Nine Months Ended September 30,			
	2014		2013	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	7,841,078	\$ 0.40	7,877,901	\$ 0.54
Effect of dilutive securities - stock options	10,657	-	14,114	-
Diluted	7,851,735	\$ 0.40	7,892,015	\$ 0.54

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Basic	7,871,016	\$ 1.25	7,867,835	\$ 1.60
Effect of dilutive securities - stock options	10,425	-	11,126	-
Diluted	7,881,441	\$ 1.25	7,878,961	\$ 1.60

Stock options on common stock which were not included in computing diluted earnings per share for the nine month periods ended September 30, 2014 and 2013, because their effects were antidilutive, averaged 120,277 and 182,620 shares, respectively.

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## Note 12 – Employee Benefit Plans

The following information pertains to the Company's non-contributory defined benefit pension plan which was frozen in 2009. If lump sum payments exceed the service cost plus interest cost, an additional settlement charge will apply.

Components of Net Periodic Benefit Cost (in thousands)	Nine Months Ended	
	September 30, 2014	2013
Service cost	\$-	\$-
Interest cost	228	216
Expected return on plan assets	(351)	(384)
Recognized net actuarial loss	54	207
Net periodic (benefit) cost	\$(69 )	\$39

## Note 13 – Segment and Related Information

The Company has two reportable segments, (i) community banking and (ii) trust and investment services.

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

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

Amounts shown in the "Other" column includes activities of the Company which are primarily debt service on trust preferred securities and corporate items. Intersegment eliminations primarily consist of the Company's investment in the Bank.

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Segment information as of and for the three and nine months ended September 30, 2014 and 2013, is shown in the following table.

(in thousands)	Three Months Ended September 30, 2014				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 11,837	\$ -	\$ 15	\$ -	\$ 11,852
Interest expense	1,206	-	186	-	1,392
Noninterest income	1,800	1,177	4	-	2,981
Income (loss) before income taxes	4,205	633	(224 )	-	4,614
Net income (loss)	2,886	430	(148 )	-	3,168
Depreciation and amortization	641	3	-	-	644
Total assets	1,317,189	-	200,757	(198,789 )	1,319,157
Capital expenditures	419	-	-	-	419

(in thousands)	Three Months Ended September 30, 2013				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 13,093	\$ -	\$ 13	\$ -	\$ 13,106
Interest expense	1,423	-	190	-	1,613
Noninterest income	1,567	1,195	5	-	2,767
Income (loss) before income taxes	5,150	849	(194 )	-	5,805
Net income (loss)	3,754	616	(127 )	-	4,243
Depreciation and amortization	757	3	-	-	760
Total assets	1,322,205	-	193,290	(191,310 )	1,324,185
Capital expenditures	139	4	-	-	143

(in thousands)	Nine Months Ended September 30, 2014				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 35,541	\$ -	\$ 45	\$ -	\$ 35,586
Interest expense	3,761	-	555	-	4,316
Noninterest income	4,770	3,600	14	-	8,384
Income (loss) before income taxes	12,355	2,284	(750 )	-	13,889
Net income (loss)	8,726	1,620	(495 )	-	9,851
Depreciation and amortization	2,154	8	-	-	2,162
Total assets	1,317,189	-	200,757	(198,789 )	1,319,157
Capital expenditures	685	-	-	-	685

(in thousands)	Nine Months Ended September 30, 2013				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 39,849	\$ -	\$ 13	\$ -	\$ 39,862
Interest expense	4,427	-	567	-	4,994
Noninterest income	5,253	2,955	15	-	8,223

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Income (loss) before income taxes	16,479	1,827	(710 )	-	17,596
Net income (loss)	11,763	1,309	(468 )	-	12,604
Depreciation and amortization	2,444	11	-	-	2,455
Total assets	1,322,205	-	193,290	(191,310 )	1,324,185
Capital expenditures	719	4	-	-	723

Note 14 – Fair Value of Financial Instruments

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the fair value measurements and disclosures topic of FASB ASC 820, "Fair Value Measurement and Disclosures", the fair value of an instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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



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## Fair Value Hierarchy

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

Level 1 –Valuation is based on quoted prices in active markets for identical assets and liabilities.

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

Level 3 Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are – unobservable in the market.

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

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). If no observable market data is available, valuations are based upon third party model based techniques (Level 3). FRB and FHLB stocks are carried at cost since no ready market exists and there is no quoted market value. The Company is required to own stock in these entities as long as it is a member. Therefore, they have been excluded from the following table.

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

Description	Fair Value Measurements at September 30, 2014			
	Balance as of September 30, 2014	Using Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$69,943	\$ -	\$ 69,943	\$ -
Mortgage-backed and CMOs	60,872	-	60,872	-
State and municipal	188,197	-	188,197	-
Corporate	8,409	-	8,409	-
Equity	1,113	-	-	1,113
Total	\$328,534	\$ -	\$ 327,421	\$ 1,113

Fair Value Measurements at December 31, 2013  
Using

Description	Balance as of December 31, 2013	Quoted	Significant	Significant
		Prices in Active Markets for Identical Assets Level 1	Other Observable Inputs Level 2	Unobservable Inputs Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$65,881	\$ -	\$ 65,881	\$ -
Mortgage-backed and CMOs	69,608	-	69,608	-
State and municipal	198,733	-	198,733	-
Corporate	10,799	-	10,799	-
Equity	1,103	-	-	1,103
Total	\$346,124	\$ -	\$ 345,021	\$ 1,103

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)

Description	Total Realized / Unrealized Gains (Losses) Included in				
	Balances as of January 1, 2014	Net Income	Other Comprehensive Income	Purchases, Sales, Issuances and Settlements, Net	Transfer In Balances as of September 30, 2014
Securities available for sale:					
Equity	\$1,103	\$ -	\$ 10	\$ -	\$ - \$1,113

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

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

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**Loans held for sale:** Loans held for sale are carried at estimated fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the nine month period ended September 30, 2014 or the year ended December 31, 2013. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

**Impaired loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected. In addition, the impairment of a loan may be measured using a present value of future cash flows analysis (Level 3). Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

**Other real estate owned:** Measurement for fair values for other real estate owned are the same as real estate collateral discussed with impaired loans.

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

Description	Fair Value Measurements at September 30, 2014 Using			
	Balance as of September 30, 2014	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Loans held for sale	\$811	\$ -	\$ 811	\$ -
Impaired loans, net of valuation allowance	2,158	-	-	2,158
Other real estate owned	2,364	-	-	2,364

Fair Value Measurements at December 31, 2013 Using

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Description	Balance as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Loans held for sale	\$2,760	\$ -	\$ 2,760	\$ -
Impaired loans, net of valuation allowance	3,193	-	-	3,193
Other real estate owned	3,422	-	-	3,422

Quantitative Information About Level 3 Fair Value Measurements for September 30, 2014

Assets	Valuation Technique	Unobservable Input	Weighted Rate
Securities available for sale	Third party model based techniques	Stock price in different rate environments	11%
Impaired loans	Discounted appraised value Discounted cash flows	Selling cost	6%
		Market rate for borrower (discount rate)	6%
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	6%

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The carrying values and estimated fair values of the Company's financial instruments at September 30, 2014 are as follows (in thousands):

	Fair Value Measurements at September 30, 2014 Using				
	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value	
Carrying Value	Level 1	Level 2	Level 3	Balance	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$80,977	\$ -	\$ 80,977	\$ -	\$80,977
Securities available for sale	328,534	-	327,421	1,113	328,534
Restricted stock	4,529	-	4,529	-	4,529
Loans held for sale	811	-	811	-	811
Loans, net of allowance	803,968	-	-	806,753	806,753
Bank owned life insurance	15,044	-	15,044	-	15,044
Accrued interest receivable	4,345	-	4,345	-	4,345
<b>Financial Liabilities:</b>					
Deposits	\$1,051,060	\$ -	\$ 691,869	\$ 361,059	\$1,052,928
Repurchase agreements	51,945	-	51,945	-	51,945
Other borrowings	9,930	-	-	10,447	10,447
Trust preferred capital notes	27,495	-	-	21,134	21,134
Accrued interest payable	581	-	581	-	581

The carrying values and estimated fair values of the Company's financial instruments at December 31, 2013 are as follows (in thousands):

	Fair Value Measurements at December 31, 2013 Using				
	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value	
Carrying Value	Level 1	Level 2	Level 3	Balance	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$67,681	\$ -	\$ 67,681	\$ -	\$67,681
Securities available for sale	346,124	-	345,021	1,103	346,124
Restricted stock	4,889	-	4,889	-	4,889
Loans held for sale	2,760	-	2,760	-	2,760
Loans, net of allowance	782,071	-	-	783,825	783,825
Bank owned life insurance	14,746	-	14,746	-	14,746

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Accrued interest receivable	4,741	-	4,741	-	4,741
Financial Liabilities:					
Deposits	\$1,057,675	\$ -	\$ 668,077	\$ 392,991	\$1,061,068
Repurchase agreements	39,478	-	39,478	-	39,478
Other borrowings	9,951	-	-	10,560	10,560
Trust preferred capital notes	27,419	-	-	18,162	18,162
Accrued interest payable	610	-	610	-	610

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

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

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

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

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

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

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

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

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

Other short-term borrowings. The carrying amount is a reasonable estimate of fair value.

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

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

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

Off-balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2014 and December 31, 2013, the fair value of off-balance sheet instruments was deemed immaterial, and therefore was not included in the previous table.

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

Note 15 – Supplemental Cash Flow Information

	Nine Months Ended September 30, 2014     2013	
Supplemental Schedule of Cash and Cash Equivalents:		
Cash and due from banks	\$22,699	\$24,071
Interest-bearing deposits in other banks	58,278	54,198
 Cash and cash equivalents	 \$80,977	 \$78,269
Supplemental Disclosure of Cash Flow Information:		
Cash paid for:		
Interest on deposits and borrowed funds	\$4,345	\$5,094
Income taxes	3,211	4,275
Noncash investing and financing activities:		
Transfer of loans to other real estate owned	386	1,549
Unrealized gains (losses) on securities available for sale	3,384	(8,191 )

Note 16 – Accumulated Other Comprehensive Income

Changes in each component of accumulated other comprehensive income ("AOCI") for the three and nine months ended September 30, 2014 and 2013 were as follows (in thousands):

	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income
For the Three Month Period			
Balance at June 30, 2013	\$ 4,353	\$ (2,203 )	\$ 2,150

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Net unrealized gains on securities available for sale, net of tax, \$67	126	-	126
Reclassification adjustment for gains on securities, net of tax, \$(1)	(3 )	-	(3 )
Balance at September 30, 2013	\$ 4,476	\$ (2,203 )	\$ 2,273
Balance at June 30, 2014	\$ 6,205	\$ (1,058 )	\$ 5,147
Net unrealized losses on securities available for sale, net of tax, \$(121)	(222 )	-	(222 )
Reclassification adjustment for gains on securities, net of tax, \$(110)	(205 )	-	(205 )
Balance at September 30, 2014	\$ 5,778	\$ (1,058 )	\$ 4,720

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For the Nine Month Period	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income
Balance at December 31, 2012	\$ 9,800	\$ (2,203 )	\$ 7,597
Net unrealized losses on securities available for sale, net of tax, \$(2,796)	(5,192 )	-	(5,192 )
Reclassification adjustment for gains on securities, net of tax, \$(71)	(132 )	-	(132 )
Balance at September 30, 2013	\$ 4,476	\$ (2,203 )	\$ 2,273
Balance at December 31, 2013	\$ 3,578	\$ (1,058 )	\$ 2,520
Net unrealized gains on securities available for sale, net of tax, \$1,360	2,528	-	2,528
Reclassification adjustment for gains on securities, net of tax, \$(176)	(328 )	-	(328 )
Balance at September 30, 2014	\$ 5,778	\$ (1,058 )	\$ 4,720

Reclassifications Out of Accumulated Other Comprehensive Income  
For the Three and Nine Month Periods Ended September 30, 2014  
(in thousands)

For the Three Month Period Ended September 30, 2014	Amount	Affected Line Item in Reclassified the Statement of Where from AOCI Net Income is Presented
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	\$ 315	Securities gains, net
	(110 )	)Income tax expense
Total reclassifications	\$ 205	Net of tax
For the Nine Month Period Ended September 30, 2014	Amount	Affected Line Item in Reclassified the Statement of Where from AOCI Net Income is Presented
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	\$ 504	Securities gains, net
	(176 )	)Income tax expense
Total reclassifications	\$ 328	Net of tax

Note 16 – Proposed Merger

On August 25, 2014, the Company announced that it had entered into an Agreement and Plan of Reorganization, dated August 24, 2014, with MainStreet Bankshares, Inc. ("MainStreet"), pursuant to which it will acquire MainStreet in a business combination transaction. MainStreet is headquartered in Martinsville, Virginia and the transaction will expand the Company's footprint into the Roanoke, Virginia metropolitan statistical area adding three branches in Franklin County. The Company expects that it will have approximately \$1.5 billion in assets upon completion of the merger.

Pursuant and subject to the terms of the merger agreement, as a result of the merger, the holders of shares of MainStreet common stock will receive 0.482 shares of the Company's common stock and \$3.46 in cash for each share of MainStreet common stock held immediately prior to the effective date of the merger.

Subject to customary closing conditions, including regulatory and shareholder approvals, the Company expects the merger to close in early January 2015. Following completion of the merger, MainStreet's subsidiary bank, Franklin Community Bank, will be merged into American National Bank and Trust Company.

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

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

### Forward-Looking Statements

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

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A variety of factors, some of which are discussed in more detail in Item 1A – Risk Factors of the Company's Annual Report on Form 10-K for the year ended December 31, 2013, 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;
- The failure of assumptions underlying the allowance for loan losses; and
- Risks associated with mergers and other acquisitions and other expansion activities.

### Reclassification

In certain circumstances, reclassifications have been made to prior period information to conform to the 2014 presentation. These reclassifications did not have an impact on net income and were considered immaterial.

### CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principles ("GAAP") and they conform to general practices within the banking industry. The Company's critical accounting policies, which are summarized below, relate to (1) the allowance for loan losses, (2) mergers and acquisitions, (3) acquired loans with specific credit-related deterioration and (4) goodwill impairment. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements contained in the Form 10-K for the year ended December 31, 2013.

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

#### Allowance for Loan Losses

The purpose of the allowance for loan losses ("ALLL") 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 goal of the Company is to maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and the provision for loan loss.

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, cash flows, collateral, and market risks, (d) regular monitoring of the portfolio, including diversification by type and geography, (e) review of loans by the Loan Review department, which operates independently of loan production, (f) regular meetings of the Credit Committees to discuss portfolio and policy changes and make decisions

on large or unusual loan requests, and (g) regular meetings of the Asset Quality Committee which reviews the status of individual loans.

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

Calculation and analysis of the ALLL is prepared quarterly by the Finance department. The Company's Credit Committee, Audit Committee, and the Board of Directors review the allowance for adequacy.

The Company's ALLL has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates and judgments.

The formula allowance uses historical loss experience as an indicator of future losses, along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries, trends in volume and terms of loans, effects of changes in underwriting standards, experience of lending staff, economic conditions, and portfolio concentrations. In the formula allowance for commercial and commercial real estate loans, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. Allowance calculations for consumer loans are calculated based on historical losses for each product category without regard to risk grade as individual risk grades are not assigned to these credits. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category.

The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. These include:

- The present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan);
- The loan's observable market price; or
- The fair value of the collateral, net of estimated selling expenses, if the loan is collateral dependent.

The use of these computed values is inherently subjective and actual losses could be greater or less than the estimates.

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

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period as facts and circumstances evolve. 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.

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### Mergers and Acquisitions

Business combinations are accounted for under the Financial Accounting Standards Board (the "FASB") Accounting Standards Codification ("ASC") 805, Business Combinations, using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company will rely on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analyses or other valuation techniques. Under the acquisition method of accounting, the Company will identify the acquirer and the closing date and apply applicable recognition principles and conditions.

Acquisition-related costs are costs the Company incurs to effect a business combination. Those costs include advisory, legal, accounting, valuation, and other professional or consulting fees. Some other examples of costs to the Company include systems conversions, integration planning consultants and advertising costs. The Company will account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities will be recognized in accordance with other applicable GAAP. These acquisition-related costs have been and will be included within the Consolidated Statements of Income classified within the noninterest expense caption.

### Acquired Loans with Specific Credit-Related Deterioration

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

### Goodwill Impairment

The Company records as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. Impairment testing is performed annually, as well as when an event triggering impairment may have occurred. The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified as of June 30, 2014.

### Non-GAAP Presentations

Non-GAAP presentations are provided because the Company believes these may be valuable to investors. These include (1) the analysis of net interest income is presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets and (2) the impact to net interest income and pretax income from accretable and amortizable fair value adjustments attributable to the merger with MidCarolina Financial Corporation ("MidCarolina") in July 2011.

### Internet Access to Corporate Documents

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

issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

## ANNOUNCED ACQUISITION

On August 25, 2014, the Company and MainStreet BankShares, Inc. ("MainStreet") (OTCBB: MREE) announced the signing of a definitive agreement that calls for MainStreet to merge with and into the Company in a transaction valued at approximately \$24.2 million at the time of the announcement. The transaction will expand the Company's footprint into the Roanoke Metropolitan Statistical Area, adds three banking offices in the Franklin County and Smith Mountain Lake areas, and will result in the Company having assets of approximately \$1.5 billion. Management expects the transaction to close in early January 2015, pending approval from MainStreet's shareholders and approval from banking regulators.

MainStreet is the holding company for Franklin Community Bank N. A. ("Franklin"). MainStreet has loans of \$127 million, assets of \$166 million, and deposits of \$139 million as of June 30, 2014. Franklin provides banking services to its customers from three banking offices located in Rocky Mount, Hardy, and Union Hall, Virginia.

## RESULTS OF OPERATIONS

### Earnings Performance

Three months ended September 30, 2014 and 2013

For the quarter ended September 30, 2014, the Company reported net income of \$3,168,000 compared to \$4,243,000 for the comparable quarter in 2013. The \$1,075,000 or 25.3% decrease in earnings was primarily due to the expected large reduction in accretion income of \$1,127,000 from the mid-2011 merger with MidCarolina.

#### SUMMARY INCOME STATEMENT

(Dollars in thousands)

			\$	%	
For the three months ended September 30,	2014	2013	Change	Change	
Interest income	\$11,852	\$13,106	\$(1,254)	-9.6	%
Interest expense	(1,392)	(1,613)	221	-13.7	%
Net interest income	10,460	11,493	(1,033)	-9.0	%
Provision for loan losses	-	-	-	-	%
Noninterest income	2,981	2,767	214	7.7	%
Noninterest expense	(8,827)	(8,455)	(372)	4.4	%
Income tax expense	(1,446)	(1,562)	116	-7.4	%
Net income	\$3,168	\$4,243	\$(1,075)	-25.3	%

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Nine months ended September 30, 2014 and 2013

For the nine month period ended September 30, 2014, the Company reported net income of \$9,851,000 compared to \$12,604,000 for the comparable period in 2013. The \$2,753,000 or 21.8% decrease in earnings was primarily due to the expected large reduction in accretion income of \$3,468,000 from the mid-2011 merger with MidCarolina.

## SUMMARY INCOME STATEMENT

(Dollars in thousands)

			\$	%	
For the nine months ended September 30,	2014	2013	Change	Change	
Interest income	\$35,586	\$39,862	\$(4,276)	-10.7	%
Interest expense	(4,316)	(4,994)	678	-13.6	%
Net interest income	31,270	34,868	(3,598)	-10.3	%
Provision for loan losses	(150)	(294)	144	-49.0	%
Noninterest income	8,384	8,223	161	2.0	%
Noninterest expense	(25,615)	(25,201)	(414)	1.6	%
Income tax expense	(4,038)	(4,992)	954	-19.1	%
Net income	\$9,851	\$12,604	\$(2,753)	-21.8	%

## Net Interest Income

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

Three months ended September 30, 2014 and 2013

Net interest income on a taxable equivalent basis decreased \$1,097,000 or 9.1%, for the third quarter of 2014 compared to the same quarter of 2013. This decline was mostly driven by lower amounts of accretion income and was partially mitigated by reduced cost of interest-bearing liabilities.

For the third quarter of 2014, the Company's yield on interest-earning assets was 4.14%, compared to 4.59% for the third quarter of 2013. The cost of interest-bearing liabilities was 0.62% compared to 0.70%. The interest rate spread was 3.52% compared to 3.89%. The net interest margin, on a fully taxable equivalent basis, was 3.68% compared to 4.06%, a reduction of thirty eight-basis points (0.38%).

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the three months ended September 30, 2014 and 2013. 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.

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Net Interest Income Analysis  
For the Three Months Ended September 30, 2014 and 2013  
(in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2014	2013	2014	2013	2014	2013
Loans:						
Commercial	\$126,340	\$126,745	\$1,339	\$1,511	4.20%	4.73%
Real estate	686,682	663,539	8,451	9,517	4.92	5.74
Consumer	4,540	5,671	85	104	7.43	7.28
Total loans	817,562	795,955	9,875	11,132	4.83	5.59
Securities:						
Federal agencies & GSEs	72,828	55,543	212	126	1.16	0.91
Mortgage-backed & CMOs	58,365	72,505	345	322	2.36	1.78
State and municipal	183,679	195,673	1,783	1,945	3.88	3.98
Other	14,583	15,861	114	116	3.13	2.93
Total securities	329,455	339,582	2,454	2,509	2.98	2.96
Deposits in other banks	45,744	54,307	32	38	0.28	0.28
Total interest-earning assets	1,192,761	1,189,844	12,361	13,679	4.14	4.59
Non-earning assets	116,359	117,503				
Total assets	\$1,309,120	\$1,307,347				
Deposits:						
Demand	\$189,208	\$163,825	15	25	0.03	0.06
Money market	167,777	184,428	51	83	0.12	0.18
Savings	88,456	84,390	10	17	0.04	0.08
Time	360,826	401,662	1,044	1,213	1.15	1.20
Total deposits	806,267	834,305	1,120	1,338	0.55	0.64
Customer repurchase agreements	45,725	46,712	2	3	0.02	0.03
Other short-term borrowings	2,215	-	2	-	0.36	-
Long-term borrowings	37,406	37,388	268	272	2.87	2.91
Total interest-bearing liabilities	891,613	918,405	1,392	1,613	0.62	0.70
Noninterest bearing demand deposits	238,646	218,819				
Other liabilities	6,368	6,993				
Shareholders' equity	172,493	163,130				
Total liabilities and shareholders' equity	\$1,309,120	\$1,307,347				
Interest rate spread					3.52%	3.89%
Net interest margin					3.68%	4.06%

Net interest income (taxable equivalent basis)	10,969	12,066
Less: Taxable equivalent adjustment	509	573
Net interest income	\$10,460	\$11,493

IndexChanges in Net Interest Income (Rate/Volume Analysis)  
(in thousands)

	Three Months Ended September 30 2014 vs. 2013		
	Interest Increase (Decrease)	Change Attributable to Rate	Volume
Interest income			
Loans:			
Commercial	\$(172 )	\$(167 )	\$(5 )
Real Estate	(1,066)	(1,389)	323
Consumer	(19 )	2	(21 )
Total loans	(1,257)	(1,554)	297
Securities:			
Federal agencies	86	41	45
Mortgage-backed	23	94	(71 )
State and municipal	(162 )	(45 )	(117 )
Other securities	(2 )	8	(10 )
Total securities	(55 )	98	(153 )
Deposits in other banks	(6 )	-	(6 )
Total interest income	(1,318)	(1,456)	138
Interest expense			
Deposits:			
Demand	(10 )	(13 )	3
Money market	(32 )	(25 )	(7 )
Savings	(7 )	(8 )	1
Time	(169 )	(49 )	(120 )
Total deposits	(218 )	(95 )	(123 )
Customer repurchase agreements	(1 )	(1 )	-
Other borrowings	(2 )	(18 )	16
Total interest expense	(221 )	(114 )	(107 )
Net interest income	\$(1,097)	\$(1,342)	\$ 245

## Nine months ended September 30, 2014 and 2013

Net interest income on a taxable equivalent basis decreased \$3,723,000 or 10.2%, for the nine months ended September 30, 2014 compared to the same period of 2013. This decline was mostly driven by lower amounts of accretion income and was partially mitigated by reduced cost of interest bearing liabilities.

For the first nine months of 2014, the Company's yield on interest-earning assets was 4.18%, compared to 4.70% for the first nine months of 2013. The cost of interest-bearing liabilities was 0.64% compared to 0.73%. The interest rate spread was 3.54% compared to 3.97%. The net interest margin, on a fully taxable equivalent basis, was 3.69% compared to 4.14%, a reduction of forty-five basis points (0.45%).

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the nine months ended September 30, 2014 and 2013. 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.

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Net Interest Income Analysis  
 For the Nine Months Ended September 30, 2014 and 2013  
 (in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2014	2013	2014	2013	2014	2013
<b>Loans:</b>						
Commercial	\$122,441	\$127,592	\$4,096	\$4,706	4.49%	4.95%
Real estate	673,745	660,698	25,072	28,927	4.96	5.84
Consumer	4,833	5,955	261	316	7.25	7.12
Total loans	801,019	794,245	29,429	33,949	4.90	5.70
<b>Securities:</b>						
Federal agencies & GSEs	73,506	51,668	617	368	1.12	0.95
Mortgage-backed & CMOs	62,420	76,286	1,116	1,040	2.38	1.82
State and municipal	189,311	192,113	5,548	5,804	3.91	4.03
Other	15,483	13,718	362	306	3.12	2.97
Total securities	340,720	333,785	7,643	7,518	2.99	3.00
Deposits in other banks	46,024	51,650	100	106	0.29	0.28
Total interest-earning assets	1,187,763	1,179,680	37,172	41,573	4.18	4.70
Non-earning assets	116,025	122,390				
Total assets	\$1,303,788	\$1,302,070				
<b>Deposits:</b>						
Demand	\$181,040	\$160,858	56	85	0.04	0.07
Money market	177,279	175,486	176	254	0.13	0.19
Savings	88,286	83,859	35	54	0.05	0.09
Time	372,253	408,826	3,243	3,750	1.17	1.23
Total deposits	818,858	829,029	3,510	4,143	0.58	0.67
Customer repurchase agreements	41,443	48,016	5	38	0.02	0.11
Other short-term borrowings	937	-	3	-	0.43	-
Long-term borrowings	37,385	37,393	798	813	2.85	2.90
Total interest-bearing liabilities	898,623	914,438	4,316	4,994	0.64	0.73
Noninterest bearing demand deposits	227,786	216,594				
Other liabilities	5,929	6,443				
Shareholders' equity	171,450	164,595				
Total liabilities and shareholders' equity	\$1,303,788	\$1,302,070				
Interest rate spread					3.54%	3.97%
Net interest margin					3.69%	4.14%

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Net interest income (taxable equivalent basis)	32,856	36,579
Less: Taxable equivalent adjustment	1,586	1,711
Net interest income	\$31,270	\$34,868

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

	Nine Months Ended September 30 2014 vs. 2013		
	Interest Increase (Decrease)	Change Rate	Attributable to Volume
Interest income			
Loans:			
Commercial	\$(610 )	\$(425 )	\$(185 )
Real Estate	(3,855)	(4,416)	561
Consumer	(55 )	6	(61 )
Total loans	(4,520)	(4,835)	315
Securities:			
Federal agencies	249	74	175
Mortgage-backed	76	287	(211 )
State and municipal	(256 )	(172 )	(84 )
Other securities	56	15	41
Total securities	125	204	(79 )
Deposits in other banks	(6 )	6	(12 )
Total interest income	(4,401)	(4,625)	224
Interest expense			
Deposits:			
Demand	(29 )	(39 )	10
Money market	(78 )	(81 )	3
Savings	(19 )	(22 )	3
Time	(507 )	(182 )	(325 )
Total deposits	(633 )	(324 )	(309 )
Repurchase agreements	(33 )	(28 )	(5 )
Other borrowings	(12 )	(32 )	20
Total interest expense	(678 )	(384 )	(294 )
Net interest income	\$(3,723)	\$(4,241)	\$ 518

## Noninterest Income

All comparisons discussed below are between the third quarter of 2014 and the third quarter of 2013.

Noninterest income increased to \$2,981,000 in 2014 from \$2,767,000 in 2013, an increase of \$214,000 or 7.7%. The major factors impacting that change are discussed below.

Fees from the management of trusts, estates, and asset management accounts decreased to \$992,000 in 2014 from \$1,077,000 in 2013, a reduction of \$85,000 or 7.9%. A substantial portion of trust fees are earned based on account market values, so changes in the equity markets may have a large impact on income.

Service charges on deposit accounts were \$441,000 in 2014 compared to \$452,000 in 2013, a decrease of \$11,000 or 2.4%.

Other fees and commissions were \$479,000 in 2014 compared to \$471,000 in 2013, an increase of \$8,000 or 1.7%.

Mortgage banking income was \$342,000 in 2014 compared to \$464,000 in 2013, a decrease of \$122,000 or 26.3%. Recent increases in mortgage interest rates have slowed demand for residential mortgage loans and have, accordingly, reduced volume and income. Secondary mortgage loan volume is down 23.6% for the quarter compared to the same quarter last year.

Securities gains were \$315,000 in 2014 compared to \$4,000 in 2013. The Company sold bonds consistent with its ongoing asset liability strategic objectives. Most of these sales were from issuers within states where management had some credit or economic concerns.

Other income was \$412,000 in 2014 compared to \$299,000 in 2013, an increase of \$113,000 or 37.8%. The major drivers of this increase were brokerage income, which was up \$66,000 from the prior year quarter, and income from an equity investment in a Small Business Investment Company ("SBIC"), which was up \$63,000 over the comparable period. Income from the SBIC investment is sporadic in nature.

#### Noninterest Expense

All comparisons discussed below are between the third quarter of 2014 and the third quarter of 2013.

Noninterest expense was \$8,827,000 in 2014 compared to \$8,455,000 in 2013, an increase of \$372,000 or 4.4%. The major factors impacting that change are discussed below.

Salaries were \$3,714,000 in 2014 compared to \$3,610,000 in 2013, an increase of \$104,000 or 2.9%.

Employee benefits were \$799,000 in 2014 compared to \$856,000 in 2013, a decrease of \$57,000 or 6.7%.

Occupancy and equipment expense was \$933,000 in 2014 and 2013.

The Federal Deposit Insurance Corporation ("FDIC") assessment for deposit insurance was \$157,000 in 2014 compared to \$163,000 in 2013, a decrease of \$6,000 or 3.7%.



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Bank franchise tax expense was \$216,000 in 2014 compared to \$187,000 in 2013, an increase of \$29,000 or 15.5% due primarily to an immaterial accrual adjustment. The bank franchise tax is computed based on the Bank's equity, net of some adjustments.

Core deposit intangible amortization was \$227,000 in 2014 compared to \$330,000 in 2013, a decrease of \$103,000 or 31.2%. Core deposit amortization from the MidCarolina acquisition is computed on an accelerated basis and will continue to decrease year over year.

Data processing expense was \$361,000 in 2014 compared to \$305,000 in 2013, an increase of \$56,000 or 18.4%. The increase is related to increased utilization of the Company's new core information management system and adding new features, e.g. instant issue debit cards.

Software expense was \$248,000 in 2014 compared to \$198,000 in 2013, an increase of \$50,000 or 25.3%. This increase was primarily due to upgrades to the Company's data processing infrastructure.

Foreclosed real estate, net, was \$141,000 for 2014 compared to \$245,000 for 2013, a decrease of \$104,000 or 42.4%. This expense category is historically volatile period to period. The expense generally fluctuates with the level of foreclosed real estate, which has been declining. Other real estate owned at September 30, 2014, was \$2,364,000, compared to \$3,422,000 at December 31, 2013.

Merger related expenses were \$268,000 in 2014 related to the pending, recently announced MainStreet BankShares, Inc. merger. These expenses were almost entirely non-deductible for income tax purposes. There were no merger related expenses in 2013. Management expects to incur further merger related costs in the fourth quarter 2014 and the first quarter 2015.

Other expenses were \$1,763,000 in 2014 compared to \$1,628,000 in 2013, an increase of \$135,000 or 8.3%.

Income Taxes

The effective tax rate for the third quarter of 2014 was 31.3% compared to 26.9% for 2013. The increase in the effective tax rate during the quarter was related mostly to non-deductible merger related costs and secondarily to federal and state tax accrual adjustments,

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

Fair Value Impact to Net Income

The following table presents the impact for the three month and nine month periods ended September 30, 2014 of the accretable and amortizable fair value adjustments attributable to the MidCarolina merger on July 1, 2011 on net interest income and pretax income:

(in thousands)	Income Statement Effect	September 30, 2014		
		Remaining Premium/ (Discount) Balance on	For the three months ended	For the Nine months ended

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December  
31, 2013

Interest income/(expense):						
Loans	Income	\$ (5,010 )	\$ 409	\$ 1,295	\$ (3,671 )	(1)
Accretable portion of loans acquired with deteriorated credit quality	Income	(2,046 )	186	862	(1,627 )	(2)
Time deposits - brokered	Income	-	-	-	-	
FHLB advances	Expense	87	(6 )	(17 )	70	
Trust preferred securities	Expense	1,964	(25 )	(76 )	1,888	
Net Interest Income			564	2,064		
Non-interest (expense)						
Amortization of core deposit intangible	Expense	\$ 2,969	(227)	(698 )	\$ 2,271	
Net non-interest expense			(227)	(698 )		
Change in pretax income			\$ 337	\$ 1,366		

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The following table presents the impact for the three month and nine month periods ended September 30, 2013 of the accretable and amortizable fair value adjustments attributable to the MidCarolina merger on July 1, 2011 on net interest income and pretax income:

(in thousands)	Income Statement Effect	September 30, 2013			
		Remaining Premium/ (Discount) Balance on December 31, 2012	For the Three Months Ended	For the Nine Months Ended	Remaining Premium/ (Discount) Balance
Interest income/(expense):					
Loans	Income	\$ (9,631 )	\$ 1,231	\$ 3,912	\$ (5,708 ) (1)
Accretable portion of loans acquired with deteriorated credit quality	Income	(2,165 )	491	1,713	(1,843 ) (2)
Time deposits - brokered	Income	(278 )	69	278	-
FHLB advances	Expense	109	(6 )	(17 )	92
Trust preferred securities	Expense	2,066	(26 )	(77 )	1,989
Net Interest Income			1,759	5,809	
Non-interest (expense)					
Amortization of core deposit intangible	Expense	\$ 4,094	(237 )	(889 )	\$ 3,205
Net non-interest expense			(237 )	(889 )	
Change in pretax income			\$ 1,522	\$ 4,920	

(1) - Remaining discount balance includes \$11 in charge-offs against the mark

(2) - Remaining discount balance includes \$1,391 in reclassifications from the non-accretable difference

## Impact of Inflation and Changing Prices

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

## CHANGES IN FINANCIAL POSITION

## BALANCE SHEET ANALYSIS

## Securities

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

The available for sale securities portfolio was \$328,534,000 at September 30, 2014 compared to \$346,124,000 at December 31, 2013, a decrease of \$17,590,000 or 5.1%. At September 30, 2014, the available for sale portfolio had an amortized cost of \$319,645,000, resulting in a net unrealized gain of \$8,889,000. At December 31, 2013, the available for sale portfolio had an amortized cost of \$340,619,000, resulting in a net unrealized gain of \$5,505,000.

The Company is aware of the relatively low, acutely uncertain current interest rate environment and has elected to maintain an investment strategy of purchasing high quality taxable securities of relatively short duration and longer term high quality, tax exempt securities, whose market values are not as volatile in rising rate environments as similarly termed taxable investments. The Company manages its investment portfolio on an aggregate portfolio basis for purposes of monitoring average life and duration. Accordingly, some individual purchases may fall outside these overall guidelines. The Company will attempt to deploy its cash to the maximum extent practical and prudent, consistent with its liquidity and asset liability strategy.

#### Loans

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

Total loans were \$816,588,000 at September 30, 2014, compared to \$794,671,000 at December 31, 2013, an increase of \$21,917,000 or 2.8%.

Loans held for sale totaled \$811,000 at September 30, 2014 and \$2,760,000 at December 31, 2013, a decrease of \$1,949,000 or 70.6%. This decrease was directly related to changes in the residential mortgage loan market, driven by increases in mortgage rates. Secondary mortgage loan volume was down 43.5% for the nine month period in 2014 compared to the same period last year.

Management of the loan portfolio is organized around segments. Each segment is comprised of various loan types that are reflective of operational and regulatory management and reporting requirements. The following table presents the Company's loan portfolio by segment as of September 30, 2014 and December 31, 2013.

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(in thousands)	September 30, 2014	December 31, 2013
Commercial	\$ 126,437	\$ 122,553
Commercial real estate:		
Construction and land development	47,060	41,822
Commercial real estate	371,743	364,616
Residential real estate:		
Residential	175,091	171,917
Home equity	90,952	87,797
Consumer	5,305	5,966
Total loans	\$ 816,588	\$ 794,671

## Allowance for Loan Losses

The purpose of the ALLL 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.

At September 30, 2014, the ALLL was \$12,620,000 compared to \$12,600,000 at December 31, 2013. The ALLL as a percentage of loans was 1.55% and 1.59%, respectively. The gradual decrease in the allowance as a percentage of loans was driven by continued good loss history combined with improving qualitative risk factors, including strong asset quality metrics and some improvement in local and national economic factors. During the first nine months of 2014, the allowance for loan losses increased by \$20,000 or 0.2%, provision expense was charged \$150,000, and the loan portfolio increased by \$21,917,000 or 2.8%.

In an effort to better evaluate the adequacy of its ALLL, the Company computes its ASC 450 loan balance by reducing total loans by acquired loans and loans that were evaluated for impairment individually or smaller balance nonaccrual loans evaluated for impairment in homogeneous pools. It also adjusts its ASC 450 loan loss reserve balance total by removing allowances associated with these other pools of loans.

The general allowance, ASC 450 (FAS 5) reserves to ASC 450 loans, was 1.58% at September 30, 2014, compared to 1.75% at December 31, 2013. On a dollar basis, the reserve was \$11,499,000 at September 30, 2014, compared to \$11,610,000 at December 31, 2013. This segment of the allowance represents by far the largest portion of the loan portfolio and the largest aggregate risk. This reserve peaked at 1.98% in December 2012, shortly after the MidCarolina merger transaction. Management considers the methodical and gradual reduction of the level of this reserve directionally consistent with the inherent risk in the loan portfolio, as evidenced by all major asset quality metrics and some improvement in economic related qualitative factors.

The specific allowance, ASC 310-40 (FAS 114) reserves to ASC 310-40 loans, was 13.43% at September 30, 2014, compared to 9.27% at December 31, 2013. On a dollar basis, the reserve was \$646,000 at September 30, 2014, compared to \$559,000 at December 31, 2013. The modest increase in the dollar amount of the reserve was related to changes in characteristics of loans reviewed individually for impairment.

The specific allowance does not include reserves related to acquired loans with deteriorated credit quality. This reserve was \$475,000 at September 30, 2014, compared to \$431,000 at December 31, 2013. This is the only portion of the reserve related to acquired loans. Cash flow expectations for these loans are reviewed on a quarterly basis and unfavorable changes in those estimates relative to the initial estimates can result in the need for specific loan loss provision.

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

Summary of Loan Loss Experience  
(in thousands)

	Nine Months Ended September 30, 2014	Year Ended December 31, 2013
Balance at beginning of period	\$ 12,600	\$ 12,118
Charge-offs:		
Construction and land development	-	-
Commercial real estate	-	164
Residential real estate	104	213
Home equity	136	156
Total real estate	240	533
Commercial and industrial	101	129
Consumer	57	175
Total charge-offs	398	837
Recoveries:		
Construction and land development	20	227
Commercial real estate	31	96
Residential real estate	52	179
Home equity	61	65
Total real estate	164	567
Commercial and industrial	42	335
Consumer	62	123
Total recoveries	268	1,025
Net charge-offs (recoveries)	130	(188 )
Provision for loan losses	150	294
Balance at end of period	\$ 12,620	\$ 12,600

IndexAsset Quality Indicators

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

## Asset Quality Ratios

	September 30, 2014	December 31, 2013	
Allowance to loans	1.55	% 1.59	%
Net charge-offs (recoveries) to allowance (1)	1.37	(1.49)	
Net charge-offs (recoveries) to average loans (1)	0.02	(0.02)	
Nonperforming assets to total assets	0.52	0.65	
Nonperforming loans to loans	0.55	0.64	
Provision to net charge-offs (recoveries) (1)	115.38	(156.38)	
Provision to average loans (1)	0.02	0.04	
Allowance to nonperforming loans	280.82	248.47	

(1) - annualized

Nonperforming Assets (Loans and Other Real Estate Owned)

Nonperforming loans include loans on which interest is no longer accrued and accruing loans that are contractually past due 90 days or more. Nonperforming loans include loans originated and loans acquired.

Nonperforming loans to total loans were 0.55% at September 30, 2014 and 0.64% at December 31, 2013.

Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming assets represented 0.52% of total assets at September 30, 2014, down from 0.65% at December 31, 2013.

In most cases, it is the policy of the Company that any loan that becomes 90 days past due will automatically be placed on nonaccrual loan status, accrued interest reversed out of income, and further interest accrual ceased. Any payments received on such loans will be credited to principal. In some cases a loan in process of renewal may become 90 days past due. In these instances the loan may still be accruing because of a delayed renewal process in which the customer has not been billed. Loans will only be restored to full accrual status after nine consecutive months of payments that were each less than 30 days delinquent.

The \$4,494,000 in nonaccrual loans shown on the following table includes: \$3,171,000 in impaired loans individually evaluated for impairment; \$756,000 in nonaccrual loan pools of smaller balance, homogenous loans, which were collectively evaluated for impairment (based on their collateral position and an improving payment history that still warrants nonaccrual status under internal policy guidelines, these loans were considered to have no dollar impairment); and \$567,000 in loans with deteriorated credit quality acquired from the MidCarolina 2011 merger.

The following table presents the Company's nonperforming assets.

## Nonperforming Assets

(in thousands)

	September 30, 2014	December 31, 2013
Nonaccrual loans:		
Real estate	\$ 4,490	\$ 5,060
Commercial	2	11
Consumer	2	-
Total nonaccrual loans	4,494	5,071
Loans past due 90 days and accruing interest:	-	-
Total nonperforming loans	4,494	5,071
Foreclosed real estate	2,364	3,422
Total nonperforming assets	\$ 6,858	\$ 8,493



IndexImpaired Loans

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

Impaired Loans (in thousands)		
	September 30, 2014	December 31, 2013
Accruing	\$ 878	\$ 958
Nonaccruing	3,928	5,071
Total impaired loans	\$ 4,806	\$ 6,029

Included in the impaired loan totals were \$2,308,000 in troubled debt restructured loans at September 30, 2014 and \$2,100,000 at December 31, 2013.

## Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets were \$2,364,000 and \$3,422,000 as of September 30, 2014 and December 31, 2013, respectively. Foreclosed assets are initially recorded at fair value, less estimated costs to sell, at the date of foreclosure. Loan losses resulting from foreclosure are charged against the ALLL at that time. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell with any additional write-downs charged against earnings. For significant assets, these valuations are typically outside annual appraisals.

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

Other Real Estate Owned (in thousands)		
	September 30, 2014	December 31, 2013
Construction and land development	\$ 1,647	\$ 1,683
1-4 family residential	556	1,400
Commercial real estate	161	339
	\$ 2,364	\$ 3,422

## Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Total deposits were \$1,051,060,000 at September 30, 2014 compared to \$1,057,675,000 at December 31, 2013, a decrease

of \$6,615,000 or 0.6%. The decline in deposits is mostly related to lower levels of time deposits. The Company will adjust its time deposit pricing strategy appropriately with current market conditions and the liquidity requirements for the Bank. The Company's primary focus on the liability side of the balance sheet is growing core deposits and their affiliated relationships. The challenge in this ongoing low rate environment is to fund the Bank in a cost effective and competitive manner. The Company's cost of deposits for the third quarter 2014 was 0.55%, down from 0.64% for the third quarter 2013.

#### Shareholders' Equity

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

Shareholders' equity was \$173,165,000 at September 30, 2014 compared to \$167,551,000 at December 31, 2013, an increase of \$5,614,000 or 3.4%.

The Company paid cash dividends of \$0.69 per share during the first nine months of 2014 while the aggregate basic and diluted earnings per share for the same period was \$1.25 per share.

Banking regulators have defined minimum regulatory capital ratios that the Company and its banking subsidiary are required to maintain. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and off-balance sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance sheet assets in relation to their perceived risk. Under the guidelines, capital strength is measured in two tiers. Tier 1 capital consists primarily of shareholders' equity and trust preferred capital notes, while Tier 2 capital consists of qualifying allowance for loan losses. At least half of the total capital is required to be Tier 1 capital, which consists principally of common and certain qualifying preferred shareholders' equity (including trust preferred securities), less certain intangibles and other adjustments. The remainder, Tier 2 capital, consists of cumulative preferred stock, long-term perpetual preferred stock, a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments) and a limited amount of the general loan loss allowance. "Total" capital is the combination of Tier 1 and Tier 2 capital. Another regulatory indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier 2 capital by average quarterly assets less intangible assets.

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The regulatory guidelines require that minimum total capital (Tier 1 plus Tier 2) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier 1 capital. At September 30, 2014, the Company's Tier 1 and total capital ratios were 17.04% and 18.30%, respectively. At December 31, 2013, these ratios were 16.88% and 18.14%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Company's leverage ratio was 12.29% and 11.81% at September 30, 2014 and December 31, 2013, 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 1 risk-based capital ratios of at least 6%, total risk-based capital ratios of at least 10%, and leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of September 30, 2014, that the Company met the requirements to be considered "well capitalized."

### Stock Repurchase Program

In prior years the Company had, in the normal course of business, operated certain stock repurchase programs. On April 17, 2014, the Company filed a Form 8-K with the SEC to announce the approval by its Board of Directors of a stock repurchase program. The program authorizes the repurchase of up to 250,000 shares of the Company's common shares over a two year period. The share purchase limit is equal to approximately 3% of the 7.9 million shares then outstanding at the time the Board approved the program.

Between late April and late May, 2014, the plan repurchased 69,784 shares at an average cost of \$21.45 per share, for a total cost of approximately \$1.5 million. Repurchase transactions have been consistently executed at less than book value per common share.

In early June 2014, the Company elected to establish a 10b5-1 plan with Raymond James & Associates, Inc. ("Raymond James"). This plan operated until October 31, 2014. The plan authorized Raymond James to buy on behalf of the Company, even during closed window periods, subject to certain price and volume limitations. The maximum number of shares that could be purchased under the 10b5-1 plan was 50,000 shares. Raymond James purchased 400 shares under the 10b5-1 plan in October 2014.

### Liquidity

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

Liquidity sources include on balance sheet and off balance sheet sources.

Balance sheet liquidity sources include cash, amounts due from banks, loan repayments, and increases in deposits. The Company also maintains a large, high quality, very liquid bond portfolio, which is generally 50% to 60% unpledged and would, accordingly, be available for sale if necessary.

Off balance sheet sources include lines of credit from the Federal Home Loan Bank of Atlanta ("FHLB"), federal funds lines of credit, and access to the Federal Reserve Bank of Richmond's discount window.

The Company has a line of credit with the FHLB, equal to 30% of the Bank's assets, subject to the amount of collateral pledged. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB. At September 30, 2014, principal advance obligations to the FHLB consisted of \$9,930,000 in fixed-rate, long-term advances compared to \$9,951,000 in fixed-rate advances at December 31, 2013. The Company also had outstanding \$72,700,000 in letters of credit at September 30, 2014 and at December 31, 2013. The letters of credit provide the Bank with alternate collateral for securing public entity deposits above FDIC insurance levels, thereby providing less need for collateral pledging from the securities portfolio.

Short-term borrowings are discussed in Note 7 and long-term borrowings are discussed in Note 8 in the Consolidated Financial Statements included in this report.

The Company has federal funds lines of credit established with two correspondent banks in the amounts of \$15,000,000 and \$10,000,000, and has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at September 30, 2014.

The Company acquired a relationship with Promontory Network, the sponsoring entity for the Certificate of Deposit Account Registry Service® ("CDARS"). Through CDARS, the Company is able to provide deposit customers with access to aggregate FDIC insurance in amounts exceeding \$250,000. This gives the Company the ability, as and when needed, to attract and retain large deposits from insurance and other safety conscious customers. CDARS are classified as brokered deposits, however they are generally derived from customers with whom the Company has or wishes to have a direct and ongoing relationship. As a result, management considers these deposits functionally, though not technically, in the same category as core deposits. With CDARS, the Company has the option to keep deposits on balance sheet or sell them to other members of the network. Additionally, subject to certain limits, the Bank can use CDARS to purchase cost-effective funding without collateralization and in lieu of generating funds through traditional brokered CDs or the FHLB. In this manner, CDARS can provide the Company with another funding option. Thus, CDARS serves as a deposit-gathering tool and an additional liquidity management tool. Deposits through the CDARS program as of September 30, 2014 and December 31, 2013, were \$23,397,000 and \$22,375,000, respectively.

Management believes that these sources provide sufficient and timely liquidity, both on and off balance sheet.

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## Off-Balance-Sheet Activities

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

	September 30, 2014	December 31, 2013
Commitments to extend credit	\$ 180,034	\$ 179,272
Standby letters of credit	3,907	3,405
Mortgage loan rate-lock commitments	6,282	5,913

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

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

Market Risk Management

Effectively managing market risk is essential to achieving the Company's financial objectives. Market risk reflects the risk of economic loss resulting from changes in interest rates and market prices. The Company is 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 in the following sections.

## 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 ALCO and Board of Directors, both of which receive and review periodic reports of the Company's interest rate risk position.

The Company uses computer 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 instrument level optionality, 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 relatively 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 September 30, 2014 is asset sensitive. Management has no expectation that market interest rates will materially decline in the near term, given the prevailing economy and apparent policy of the Board of Governors of the Federal Reserve System.

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## Earnings Simulation

The following tables shows the estimated impact of changes in interest rates on net interest income as of September 30, 2014 assuming instantaneous rate shocks, 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.

Estimated Changes in Net Interest Income  
(dollars in thousands)

	September 30, 2014	
	Change in Net Interest Income	
Change in interest rates	Amount	Percent
Up 4.00%	\$6,935	16.7 %
Up 3.00%	5,182	12.5 %
Up 2.00%	3,412	8.2 %
Up 1.00%	1,606	3.9 %
Flat	-	-
Down 0.25%	(537 )	-1.3 %
Down 0.50%	(1,242)	-3.0 %

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.

## Economic Value Simulation

Economic value simulation is used to calculate the estimated fair value of assets and liabilities over different interest rate environments. Economic values are calculated based on discounted cash flow analysis. The net economic value of equity is the economic value of all assets minus the economic value of all liabilities. The change in net economic value over different rate environments is an indication of the longer-term earnings capability of the balance sheet. The same assumptions are used in the economic value simulation as in the earnings simulation. The economic value simulation uses instantaneous rate shocks to the balance sheet.

The following table reflects the estimated change in net economic value over different rate environments using economic value simulation for the balances at the period ended September 30, 2014 (dollars in thousands):

Estimated Changes in Economic Value of Equity  
(dollars in thousands)

September 30, 2014

Change in interest rates	Amount	\$	%	
		Change	Change	
Up 4.00%	\$223,029	\$28,283	14.5	%
Up 3.00%	218,409	23,663	12.2	%
Up 2.00%	212,300	17,554	9.0	%
Up 1.00%	204,044	9,298	4.8	%
Flat	194,746	-	-	
Down 0.25%	191,344	(3,402 )	-1.7	%
Down 0.50%	186,910	(7,836 )	-4.0	%

Increases in interest rates over the past two quarters have had a negative impact on the economic value of the Company's assets. However, this has been more than offset by the positive impact the rate increases have had on the economic value of the Company's liabilities.

Due to the current low interest rate environment, no measurement was considered necessary for a further decline in interest rates.

There have been no material changes to market risk as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. Refer to those disclosures for further information.



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## ITEM 4. CONTROLS AND PROCEDURES

## Disclosure Controls and Procedures

The Company's management, including the Chief Executive Officer and Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), as of September 30, 2014. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended September 30, 2014, that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

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

## ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 filed with the SEC on March 12, 2014.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On April 17, 2014, the Company's Board of Directors authorized a share repurchase program of up to 250,000 shares of the Company's outstanding common stock for a period of two years. Repurchases may be made through open market purchases or in privately negotiated transactions, and shares repurchased will be returned to the status of authorized and unissued shares of common stock. The actual timing, number, and value of shares repurchased under the program will be determined by management.

The following schedule summarizes the Company's total monthly stock repurchase activity for the three months ended September 30, 2014:

Period Beginning on First Day of Month Ended	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under Plans or Programs
August	400	21.04	400	179,816

Total	400	\$ 21.04	400
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ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

ITEM 6. EXHIBITS

11.0 Refer to EPS calculation in the Notes to Financial Statements

31.1 Section 302 Certification of Jeffrey V. Haley, President and Chief Executive Officer

31.2 Section 302 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer

32.1 Section 906 Certification of Jeffrey V. Haley, President and Chief Executive Officer

32.2 Section 906 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer

101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets as of September 30, 2014, December 31, 2013 and September 30, 2013, (ii) the Consolidated Statements of Income for the three and nine months ended September 30, 2014 and September 30, 2013, (iii) the Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2014 and September 30, 2013, (iv) the Consolidated Statements of Changes in Shareholders' Equity for the nine months ended September 30, 2014 and September 30, 2013, (v) the Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and September 30, 2013 and (vi) the Notes to the Consolidated Financial Statements (furnished herewith).

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SIGNATURES

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

AMERICAN NATIONAL BANKSHARES INC.

/s/ Jeffrey V. Haley

Jeffrey V. Haley

Date – November 10, 2014 President and Chief Executive Officer

/s/ William W. Traynham

William W. Traynham

Senior Vice President and

Date – November 10, 2014 Chief Financial Officer