

Village Bank & Trust Financial Corp.  
Form 10-Q  
May 16, 2011

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

FORM 10-Q  
QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2011

TRANSITION REPORT UNDER SECTION 13 OR 15(d)  
OF THE EXCHANGE ACT

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

Commission file number: 0-50765

VILLAGE BANK AND TRUST FINANCIAL CORP.  
(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction  
of incorporation)

16-1694602  
(IRS Employer  
Identification No.)

15521 Midlothian Turnpike, Midlothian, Virginia  
(Address of principal executive offices)

23113  
(Zip Code)

804-897-3900  
(Registrant's telephone number, including area code)

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

Indicate by check mark 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 (or for such shorter period that the registrant was required to submit and post such files). Yes  No .

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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 <input type="checkbox"/>   | Accelerated Filer <input type="checkbox"/>                    |
| Non-Accelerated Filer <input type="checkbox"/> (Do not check if smaller reporting company) | Smaller Reporting Company <input checked="" type="checkbox"/> |

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

4,243,378 shares of common stock, \$4.00 par value, outstanding as of May 8, 2011

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Village Bank and Trust Financial Corp.  
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## PART I – FINANCIAL INFORMATION

## ITEM 1 – FINANCIAL STATEMENTS

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Balance Sheets  
March 31, 2011 and December 31, 2010

|   | March 31,<br>2011<br>(Unaudited) | December 31,<br>2010 |
|---|----------------------------------|----------------------|
| <b>Assets</b>   |                                  |                      |
| Cash and due from banks   | \$ 12,765,062                    | \$ 9,390,377         |
| Federal funds sold  | 8,751,212                        | 2,621,934            |
| Investment securities available for sale  | 81,810,230                       | 53,597,174           |
| Loans held for sale   | 8,629,602                        | 19,871,787           |
| <b>Loans</b>  |                                  |                      |
| Outstandings  | 442,720,243                      | 453,242,950          |
| Allowance for loan losses   | (7,434,283 )                     | (7,311,712 )         |
| Deferred fees and costs   | 666,247                          | 623,851              |
|   | 435,952,207                      | 446,555,089          |
| Premises and equipment, net   | 27,416,915                       | 27,437,452           |
| Accrued interest receivable   | 2,536,961                        | 2,347,211            |
| Bank owned life insurance   | 5,917,952                        | 5,871,765            |
| Other real estate owned   | 13,505,097                       | 12,028,111           |
| Other assets  | 10,978,196                       | 12,058,315           |
|   | \$ 608,263,434                   | \$ 591,779,215       |
| <b>Liabilities and Stockholders' Equity</b>   |                                  |                      |
| <b>Liabilities</b>  |                                  |                      |
| <b>Deposits</b>   |                                  |                      |
| Noninterest bearing   | \$ 46,035,898                    | \$ 41,036,262        |
| Interest bearing  | 458,923,419                      | 457,975,931          |
| Total deposits  | 504,959,317                      | 499,012,193          |
| Federal Home Loan Bank advances   | 38,750,000                       | 28,750,000           |
| Long-term debt - trust preferred securities   | 8,764,000                        | 8,764,000            |
| Other borrowings  | 5,241,499                        | 4,165,430            |
| Accrued interest payable  | 454,712                          | 404,801              |
| Other liabilities   | 1,934,474                        | 2,362,597            |
| Total liabilities   | 560,104,002                      | 543,459,021          |
| <b>Stockholders' equity</b>   |                                  |                      |
| Preferred stock, \$4 par value, \$1,000 liquidation preference,<br>1,000,000 shares authorized, 14,738 shares issued and outstanding  | 58,952                           | 58,952               |
| Common stock, \$4 par value - 10,000,000 shares authorized<br>4,243,378 shares issued and outstanding at March 31, 2011<br>4,238,416 shares issued and outstanding at December 31, 2010 | 16,973,512                       | 16,953,664           |
| Additional paid-in capital  | 40,643,345                       | 40,633,581           |

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|                                      |               |               |
|--------------------------------------|---------------|---------------|
| Retained earnings (deficit)          | (9,327,890 )  | (9,192,552 )  |
| Common stock warrant                 | 732,479       | 732,479       |
| Discount on preferred stock          | (456,099 )    | (492,456 )    |
| Accumulated other comprehensive loss | (464,867 )    | (373,474 )    |
| Total stockholders' equity           | 48,159,432    | 48,320,194    |
|                                      | \$608,263,434 | \$591,779,215 |

See accompanying notes to consolidated financial statements

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Income  
Three Months Ended March 31, 2011 and 2010  
(Unaudited)

|   | Three Months Ended March 31, |              |
|---|------------------------------|--------------|
|   | 2011                         | 2010         |
| Interest income                                     |                              |              |
| Loans   | \$ 7,040,768                 | \$ 7,089,244 |
| Investment securities                               | 300,326                      | 357,120      |
| Federal funds sold                                  | 18,323                       | 14,232       |
| Total interest income                               | 7,359,417                    | 7,460,596    |
| Interest expense                                    |                              |              |
| Deposits  | 2,038,876                    | 2,510,967    |
| Borrowed funds                                      | 282,691                      | 533,820      |
| Total interest expense                              | 2,321,567                    | 3,044,787    |
| Net interest income                                 | 5,037,850                    | 4,415,809    |
| Provision for loan losses                           | 1,003,000                    | 500,000      |
| Net interest income after provision for loan losses | 4,034,850                    | 3,915,809    |
| Noninterest income                                  |                              |              |
| Service charges and fees                            | 372,950                      | 407,689      |
| Gain on sale of loans                               | 1,372,678                    | 1,171,954    |
| Gain on sale of assets                              | 63,125                       | 242,936      |
| Rental income                                       | 151,937                      | 103,671      |
| Other   | 94,518                       | 227,720      |
| Total noninterest income                            | 2,055,208                    | 2,153,970    |
| Noninterest expense                                 |                              |              |
| Salaries and benefits                               | 3,050,116                    | 2,767,389    |
| Occupancy   | 493,224                      | 509,918      |
| Equipment   | 220,070                      | 217,724      |
| Supplies  | 116,159                      | 134,362      |
| Professional and outside services                   | 566,354                      | 522,809      |
| Advertising and marketing                           | 122,839                      | 89,626       |
| Expenses related to foreclosed real estate          | 462,316                      | 209,828      |
| FDIC insurance premium                              | 333,208                      | 292,168      |
| Other operating expense                             | 533,652                      | 586,805      |
| Total noninterest expense                           | 5,897,938                    | 5,330,629    |
| Net income before income taxes                      | 192,120                      | 739,150      |
| Income tax expense                                  | 109,400                      | 251,311      |
| Net income  | 82,720                       | 487,839      |

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|   |               |            |
|---|---------------|------------|
| Preferred stock dividends and accretion of discount | 218,058       | 217,688    |
| Net income (loss) available to common shareholders  | \$ (135,338 ) | \$ 270,151 |
| Earnings (loss) per share, basic                    | \$ (0.03 )    | \$ 0.06    |
| Earnings (loss) per share, diluted                  | \$ (0.03 )    | \$ 0.06    |

See accompanying notes to consolidated financial statements



Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Stockholders' Equity  
and Comprehensive Income  
Three Months Ended March 31, 2011 and 2010  
(Unaudited)

|  | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings<br>(Deficit) | Warrant   | Accumulated                          |  | Total        |
|--|--------------------|-----------------|----------------------------------|-----------------------------------|-----------|--------------------------------------|--|--------------|
|  |                    |                 |                                  |                                   |           | Discount<br>on<br>Preferred<br>Stock | Other<br>Comprehensive<br>Income<br>(loss) |              |
| Balance,<br>December 31,<br>2010   | \$58,952           | \$16,953,664    | \$40,633,581                     | \$(9,192,552)                     | \$732,479 | \$(492,456)                          | \$(373,474)                                | \$48,320,194 |
| Amortization of<br>preferred stock<br>discount   | -                  | -               | -                                | (36,357)                          | -         | 36,357                               | -  | -            |
| Preferred stock<br>dividend  | -                  | -               | -                                | (181,701)                         | -         | -                                    | -  | (181,701)    |
| Issuance of<br>common stock  | -                  | 19,848          | (19,848)                         | -                                 | -         | -                                    | -  | -            |
| Stock based<br>compensation  | -                  | -               | 29,612                           | -                                 | -         | -                                    | -  | 29,612       |
| Minimum pension<br>adjustment<br>(net of income<br>taxes of \$1,105)   | -                  | -               | -                                | -                                 | -         | -                                    | 2,145                                      | 2,145        |
| Net income   | -                  | -               | -                                | 82,720                            | -         | -                                    | -  | 82,720       |
| Change in<br>unrealized gain on<br>investment<br>securities<br>available-for-sale,<br>net of<br>reclassification<br>and tax effect | -                  | -               | -                                | -                                 | -         | -                                    | (93,538)                                   | (93,538)     |
| Total<br>comprehensive<br>income   | -                  | -               | -                                | -                                 | -         | -                                    | -  | (8,673)      |
| Balance, March<br>31, 2011   | \$58,952           | \$16,973,512    | \$40,643,345                     | \$(9,327,890)                     | \$732,479 | \$(456,099)                          | \$(464,867)                                | \$48,159,432 |
| Balance,<br>December 31,<br>2009   | \$58,952           | \$16,922,512    | \$40,568,771                     | \$(8,647,731)                     | \$732,479 | \$(636,959)                          | \$(56,205)                                 | \$48,941,819 |

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|   |          |              |              |               |           |             |            |              |
|---|----------|--------------|--------------|---------------|-----------|-------------|------------|--------------|
| Amortization of preferred stock discount  | -        | -            | (35,988 )    | -             | 35,988    | -           | -          |              |
| Preferred stock dividend  | -        | -            | (181,700 )   | -             | -         | -           | (181,700 ) |              |
| Issuance of common stock  | -        | -            | -            | -             | -         | -           | -          |              |
| Stock based compensation  |          |              | 30,044       |               |           |             | 30,044     |              |
| Minimum pension adjustment (net of income taxes of \$1,105)   | -        | -            | -            | -             | -         | 2,145       | 2,145      |              |
| Net income  | -        | -            | -            | 487,839       | -         | -           | 487,839    |              |
| Change in unrealized gain on investment securities available-for-sale, net of reclassification and tax effect | -        | -            | -            | -             | -         | -           | 80,871     |              |
| Total comprehensive income  | -        | -            | -            | -             | -         | -           | 570,855    |              |
| Balance, March 31, 2010   | \$58,952 | \$16,922,512 | \$40,598,815 | \$(8,377,580) | \$732,479 | \$(600,971) | \$26,811   | \$49,361,018 |

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Cash Flows  
Three Months Ended March 31, 2011 and 2010  
(Unaudited)

|   | 2011          | 2010          |
|---|---------------|---------------|
| Cash Flows from Operating Activities  |               |               |
| Net income  | \$ 82,720     | \$ 487,839    |
| Adjustments to reconcile net income to net cash provided by operating activities: |               |               |
| Depreciation and amortization   | 350,499       | 315,000       |
| Deferred income taxes   | (3,710,085 )  | (4,046,825 )  |
| Provision for loan losses   | 1,003,000     | 500,000       |
| Write-down of other real estate owned   | 362,237       | 43,000        |
| Gain on securities sold   | (63,125 )     | (108,213 )    |
| Gain on loans sold  | (1,372,678 )  | (1,171,954 )  |
| (Gain) loss on sale of premises and equipment                                     | -             | (242,936 )    |
| Gain on sale of other real estate owned   | (6,467 )      | (68,475 )     |
| Stock compensation expense  | 29,612        | 30,044        |
| Proceeds from sale of other real estate owned                                     | 555,152       | 1,568,051     |
| Proceeds from sale of mortgage loans  | 55,513,663    | 49,053,958    |
| Origination of mortgage loans for sale  | (42,898,800 ) | (50,901,191 ) |
| Amortization of premiums and accretion of discounts on securities, net            | 26,737        | 209,813       |
| (Increase) decrease in interest receivable  | (189,750 )    | 834,122       |
| Increase in bank owned life insurance   | (46,187 )     | (57,250 )     |
| (Increase) decrease in other assets   | 4,840,536     | 4,326,703     |
| Increase (decrease) in interest payable   | 49,911        | (17,501 )     |
| Decrease in other liabilities   | (428,122 )    | (274,734 )    |
| Net cash used in operating activities   | 14,098,853    | 479,451       |
| Cash Flows from Investing Activities  |               |               |
| Purchases of available for sale securities  | (54,960,337 ) | (2,950,740 )  |
| Proceeds from the sale of calls of available for sale securities                  | 803,100       | 299,054       |
| Proceeds from maturities and principal payments of available for sale securities  | 25,838,844    | 16,162,000    |
| Net increase in loans   | 7,211,973     | 154,043       |
| Purchases of premises and equipment   | (329,962 )    | (335,423 )    |
| Proceeds from sale of premises and equipment                                      | -             | 377,321       |
| Net cash (used in) provided by investing activities                               | (21,436,382 ) | 13,706,255    |
| Cash Flows from Financing Activities  |               |               |
| Net increase (decrease) in deposits   | 5,947,124     | 12,692,158    |
| Net increase (decrease) in federal home loan bank advances                        | 10,000,000    |               |
| Net increase (decrease) in other borrowings                                       | 1,076,069     | (358,791 )    |
| Dividends on preferred stock  | (181,701 )    | (181,700 )    |

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|  |               |               |
|--|---------------|---------------|
| Net cash provided by financing activities                | 16,841,492    | 12,151,667    |
| Net increase in cash and cash equivalents                | 9,503,963     | 26,337,373    |
| Cash and cash equivalents, beginning of period           | 12,012,311    | 20,661,820    |
| Cash and cash equivalents, end of period                 | \$ 21,516,274 | \$ 46,999,193 |
| Supplemental Schedule of Non Cash Activities             |               |               |
| Real estate owned assets acquired in settlement of loans | \$ 2,387,908  | \$ 978,635    |

See accompanying notes to consolidated financial statements.

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 - Principles of presentation

Village Bank and Trust Financial Corp. (the “Company”) is the holding company of Village Bank (the “Bank”). The consolidated financial statements include the accounts of the Company, the Bank and the Bank’s three wholly-owned subsidiaries, Village Bank Mortgage Company, Village Insurance Agency, Inc., and Village Financial Services Company. All material intercompany balances and transactions have been eliminated in consolidation.

The Company’s financial statements are prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) which, effective for all interim and annual periods ending after September 15, 2009, principally consist of the Financial Accounting Standards Board Accounting Standards Codification (“FASB Codification”). FASB Codification Topic 105: Generally Accepted Accounting Principles establishes the FASB codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the Securities and Exchange Commission (“SEC”) under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the FASB Codification carries an equal level of authority. All non-grandfathered, non-SEC accounting literature not included in the FASB Codification is superseded and deemed non-authoritative.

In the opinion of management, the accompanying condensed consolidated financial statements of the Company have been prepared on the accrual basis in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, all adjustments that are, in the opinion of management, necessary for a fair presentation have been included. The results of operations for the three month period ended March 31, 2011 is not necessarily indicative of the results to be expected for the full year ending December 31, 2011. The unaudited interim financial statements should be read in conjunction with the audited financial statements and notes to financial statements that are presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010 as filed with the Securities and Exchange Commission.

Note 2 - Use of estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the statements of financial condition and revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

Note 3 – Earnings (loss) per common share

The following table presents the basic and diluted earnings per share computations:

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|   | Three Months Ended March 31, |            |
|---|------------------------------|------------|
|   | 2011                         | 2010       |
| Numerator   |                              |            |
| Net income (loss) - basic and diluted                               | \$ 82,720                    | \$ 487,839 |
| Preferred stock dividend and accretion                              | 218,058                      | 217,689    |
| Net income (loss) available to common shareholders                  | \$ (135,338 )                | \$ 270,150 |
| Denominator   |                              |            |
| Weighted average shares outstanding - basic                         | 4,241,945                    | 4,230,628  |
| Dilutive effect of common stock options and restricted stock awards | -                            | -          |
| Weighted average shares outstanding - diluted                       | 4,241,945                    | 4,230,628  |
| Earnings (loss) per share - basic and diluted                       |                              |            |
| Earnings (loss) per share - basic                                   | \$ (0.03 )                   | \$ 0.06    |
| Effect of dilutive common stock options                             | -                            | -          |
| Earnings (loss) per share - diluted                                 | \$ (0.03 )                   | \$ 0.06    |

Outstanding options and warrants to purchase common stock were considered in the computation of diluted earnings per share for the periods presented. Stock options for 310,205 and 336,005 shares of common stock were not included in computing diluted earnings per share for the three months ended March 31, 2011 and 2010, respectively, because their effects were anti-dilutive. Warrants for 499,029 shares of common stock were not included in computing earnings per share in 2011 and 2010 because their effects were also anti-dilutive.

Note 4 – Loans and Allowance for Loan Losses

The following table presents the composition of our loan portfolio (excluding mortgage loans held for sale) at the dates indicated.

|  | Loan Portfolio, Net<br>(In thousands) |       |   |                   |       |   |
|--|---------------------------------------|-------|---|-------------------|-------|---|
|  | March 31, 2011                        |       |   | December 31, 2010 |       |   |
|  | Amount                                | %     |   | Amount            | %     |   |
| Commercial   | \$ 35,415                             | 8.0   | % | \$ 37,228         | 8.2   | % |
| Real estate - Construction, land development & other loans | 87,933                                | 19.9  | % | 90,773            | 20.0  | % |
| Real estate - Commercial                                   | 166,207                               | 37.5  | % | 173,227           | 38.2  | % |
| Real estate - 1-4 Residential                              | 147,696                               | 33.4  | % | 146,647           | 32.4  | % |
| Consumer   | 5,469                                 | 1.2   | % | 5,368             | 1.2   | % |
| Total loans  | 442,720                               | 100.0 | % | 453,243           | 100.0 | % |
|  | 666                                   |       |   | 624               |       |   |

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|   |            |            |
|---|------------|------------|
| Deferred loan cost (unearned income), net |            |            |
| Less: Allowance for loan losses           | (7,434 )   | (7,312 )   |
| Total loans, net                          | \$ 435,952 | \$ 446,555 |

The Company assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

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- Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. 1-4 assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
- Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;
- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any, and;
- Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

|   | Risk Rated<br>1-4 | Risk Rated<br>5 | Risk Rated<br>6 | Risk Rated<br>7 | Total<br>Loans |
|---|-------------------|-----------------|-----------------|-----------------|----------------|
| Commercial  | \$28,477,734      | \$2,927,082     | \$3,486,526     | \$523,868       | \$35,415,210   |
| Real estate - Construction, land<br>development & other loans | 59,664,988        | 3,750,564       | 24,516,852      | -               | 87,932,404     |
| Real estate - Commercial                                      | 116,749,553       | 23,635,110      | 25,629,443      | 193,251         | 166,207,357    |
| Real estate - 1-4 Residential                                 | 131,407,250       | 5,892,408       | 10,232,721      | 163,825         | 147,696,204    |
| Consumer  | 4,313,495         | 745,905         | 302,702         | 106,966         | 5,469,068      |
| Total loans   | \$340,613,020     | \$36,951,069    | \$64,168,244    | \$987,910       | \$442,720,243  |

The following table presents the aging of the recorded investment in past due loans and leases as of March 31, 2011:

|  | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>Than<br>90 Days | Total Past<br>Due | Current       | Total<br>Loans | Recorded<br>Investment<br>><br>90 Days<br>and<br>Accruing |
|--|------------------------|------------------------|----------------------------|-------------------|---------------|----------------|---|
| Commercial   | \$381,958              | \$381,974              | \$11,926                   | \$775,858         | \$34,639,352  | \$35,415,210   | \$11,926  |
| Real estate -<br>Construction,<br>land<br>development &<br>other loans | 4,017,664              | 196,564                | -                          | 4,214,228         | 83,718,176    | 87,932,404     | -   |
| Real estate -<br>Commercial  | 3,517,265              | 268,443                | 173,213                    | 3,958,921         | 162,248,436   | 166,207,357    | 173,213   |
| Real estate - 1-4<br>Residential                                       | 5,503,828              | 1,625,973              | 228,175                    | 7,357,976         | 140,338,228   | 147,696,204    | 228,175   |
| Consumer   | 106,659                | -                      | 26,574                     | 133,233           | 5,335,835     | 5,469,068      | 26,574  |
| Total  | \$13,527,374           | \$2,472,954            | \$439,888                  | \$16,440,216      | \$426,280,027 | \$442,720,243  | \$439,888   |



Loans are considered impaired when, based on current information and events it is probably the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Impaired loans at March 31, 2011 are set forth in the following table.

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| Description of Loans   | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded Investment             |   |  | Related<br>Allowance | Recorded<br>Average<br>Investment |
|--|---|---------------------------------|---|--|----------------------|-----------------------------------|
|  |   | Total<br>Recorded<br>Investment | Recorded<br>Investment<br>with<br>Allowance | Recorded<br>Investment<br>With No<br>Allowance |                      |                                   |
| Commercial   | \$3,128,283                                   | \$2,936,225                     |   | \$2,936,225                                    |                      | \$2,342,004                       |
| Real estate - Construction,<br>land development & other<br>loans | 7,937,685                                     | 6,793,373                       | \$372,155                                   | 6,421,218                                      | \$50,000             | 5,726,924                         |
| Real estate - Commercial   | 2,032,248                                     | 1,603,604                       |   | 1,603,604                                      |                      | 5,589,010                         |
| Real estate - 1-4 Residential                                    | 7,096,355                                     | 6,080,588                       | 236,991                                     | 5,843,597                                      | 41,500               | 5,153,596                         |
| Consumer   | 155,854                                       | 153,782                         | -   | 153,782  | -                    | 117,295                           |
|  | \$20,350,425                                  | \$17,567,572                    | \$609,146                                   | \$16,958,426                                   | \$91,500             | \$18,928,829                      |

Activity in the allowance for loan losses is as follows (in thousands):

|                              | Commercial | Real estate<br>Construction,<br>land<br>development<br>and other | Real estate<br>Commercial | Real estate<br>1-4<br>Residential | Consumer | Total    |
|------------------------------|------------|--|---------------------------|-----------------------------------|----------|----------|
| Balance December 31,<br>2011 | 819        | 2,265  | 2,899                     | 1,090                             | 239      | 7,312    |
| Charge-offs                  | (474 )     | (83 )  | (327 )                    | -                                 | -        | (884 )   |
| Recoveries                   | 2          | -  |                           | 1                                 | -        | 3        |
| Provision                    | 300        | 500  | 203                       |                                   |          | 1,003    |
| March 31, 2011               | 647        | 2,682  | 2,775                     | 1,091                             | 239      | 7,434    |
| Balance December 31,<br>2009 | 710        | 3,500  | 4,442                     | 355                               | 1,515    | 10,522   |
| Charge-offs                  | (183 )     | (1,881 )   | (5,067 )                  | (191 )                            | (1,044 ) | (8,366 ) |
| Recoveries                   | 2          | 121  | 187                       | 2                                 | 2        | 314      |
| Provision                    | 290        | 1,159  | 2,703                     | 73                                | 617      | 4,842    |
| December 31, 2011            | 819        | 2,899  | 2,265                     | 239                               | 1,090    | 7,312    |

Note 5 – Investment securities

At March 31, 2011 and December 31, 2010, all of our securities were classified as available-for-sale. The following table presents the composition of our investment portfolio at the dates indicated.



Investment Securities Available-for-Sale  
(Dollars in thousands)

|                             | Par<br>Value | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value | Average<br>Yield |
|-----------------------------|--------------|-------------------|------------------------------|-------------------------------|----------------------------|------------------|
| March 31, 2011              |              |                   |                              |                               |                            |                  |
| US Treasuries               |              |                   |                              |                               |                            |                  |
| One to five years           | \$ 36,000    | \$ 36,016         | -                            | \$ (67 )                      | \$ 35,949                  | 0.17 %           |
| US Government Agencies      |              |                   |                              |                               |                            |                  |
| Five to ten years           | 6,000        | 5,998             | 1                            | (111 )                        | 5,888                      | 2.62 %           |
| Mortgage-backed securities  |              |                   |                              |                               |                            |                  |
| One to five years           | 192          | 203               | -                            | (7 )                          | 196                        | 2.68 %           |
| Five to ten years           | 1,964        | 2,002             | -                            | (27 )                         | 1,975                      | 2.47 %           |
| More than ten years         | 30,489       | 30,893            | 169                          | (208 )                        | 30,854                     | 2.89 %           |
| Total                       | 32,645       | 33,098            | 169                          | (242 )                        | 33,025                     | 2.86 %           |
| Municipals                  |              |                   |                              |                               |                            |                  |
| More than ten years         | 6,000        | 6,059             | -                            | (290 )                        | 5,769                      | 4.69 %           |
| Other investments           |              |                   |                              |                               |                            |                  |
| More than ten years         | 1,178        | 1,178             | 1                            |                               | 1,179                      | 0.67 %           |
| Total investment securities | \$ 81,823    | \$ 82,349         | \$ 171                       | \$ (710 )                     | \$ 81,810                  | 1.76 %           |
| December 31, 2010           |              |                   |                              |                               |                            |                  |
| US Treasuries               |              |                   |                              |                               |                            |                  |
| One to five years           | \$ 28,000    | \$ 28,017         | \$ -                         | \$ -                          | \$ 28,017                  | 0.22 %           |
| US Government Agencies      |              |                   |                              |                               |                            |                  |
| Five to ten years           | 3,000        | 3,000             |                              | (111 )                        | 3,000                      | 2.00 %           |
| Mortgage-backed securities  |              |                   |                              |                               |                            |                  |
| One to five years           | 686          | 703               | 31                           | (10 )                         | 734                        | 4.90 %           |
| More than ten years         | 14,410       | 14,796            | 91                           | (58 )                         | 14,887                     | 2.86 %           |
| Total                       | 15,096       | 15,499            | 122                          | (68 )                         | 15,621                     | 5.39 %           |
| Municipals                  |              |                   |                              |                               |                            |                  |
| More than ten years         | 6,000        | 6,060             | -                            | (337 )                        | 6,060                      | 4.69 %           |
| Other investments           |              |                   |                              |                               |                            |                  |

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|                             |           |           |        |           |           |        |
|-----------------------------|-----------|-----------|--------|-----------|-----------|--------|
| More than ten years         | 1,418     | 1,418     | -      | (3 )      | 1,418     | 0.69 % |
| Total investment securities | \$ 53,514 | \$ 53,994 | \$ 122 | \$ (519 ) | \$ 54,116 | 2.32 % |

Investment securities available for sale that have an unrealized loss position at March 31, 2011 and December 31, 2010 are detailed below.

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| March 31, 2011                              | Securities in a loss<br>Position for less than<br>12 Months |                      | Securities in a loss<br>Position for more than<br>12 Months |                      | Total         |                      |
|---|---|----------------------|---|----------------------|---------------|----------------------|
|   | Fair<br>Value   | Unrealized<br>Losses | Fair Value<br>(Loss)  | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| Investment Securities<br>available for sale |   |                      |   |                      |               |                      |
| US Government<br>Agencies                   | \$ 40,337   | \$ (178 )            | \$ -  | \$ -                 | \$ 40,337     | \$ (178 )            |
| Mortgage-backed<br>securities               | 19,598  | (230 )               | 396   | (11 )                | 19,994        | (241 )               |
| Municipals                                  | 5,769   | (290 )               |   |                      |               |                      |
| Total                                       | \$ 65,704   | \$ (698 )            | \$ 396  | \$ (11 )             | \$ 60,331     | \$ (419 )            |

| December 31, 2010                           | Securities in a loss<br>Position for less than<br>12 Months |                      | Securities in a loss<br>Position for more than<br>12 Months |                      | Total         |                      |
|---|---|----------------------|---|----------------------|---------------|----------------------|
|   | Fair<br>Value   | Unrealized<br>Losses | Fair Value<br>(Loss)  | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| Investment Securities<br>available for sale |   |                      |   |                      |               |                      |
| US Treasuries                               | \$ 30,286   | \$ (114 )            | \$ -  | \$ -                 | \$ 30,286     | \$ (114 )            |
| Mortgage-backed<br>securities               | 7,079   | (68 )                |   |                      | 7,079         | (68 )                |
| Municipals                                  | 5,723   | (337 )               | -   | -                    | 5,723         | (337 )               |
| Total                                       | \$ 43,088   | \$ (519 )            | \$ -  | \$ -                 | \$ 43,088     | \$ (519 )            |

Management does not believe that any individual unrealized loss as of March 31, 2011 and December 31, 2010 is other than a temporary impairment. These unrealized losses are primarily attributable to changes in interest rates. As of March 31, 2011, management does not have the intent to sell any of the securities classified as available for sale and management believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

Note 6 – Deposits

Deposits as of March 31, 2011 and December 31, 2010 were as follows:

| March 31, 2011 |   | December 31, 2010 |   |
|----------------|---|-------------------|---|
| Amount         | % | Amount            | % |

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|                                     |               |        |   |               |        |   |
|-------------------------------------|---------------|--------|---|---------------|--------|---|
| Noninterest bearing demand          | \$46,035,898  | 9.12   | % | \$41,036,262  | 8.22   | % |
| Interest checking accounts          | 36,973,233    | 7.32   | % | 33,291,777    | 6.67   | % |
| Money market accounts               | 91,235,718    | 18.07  | % | 90,156,362    | 18.07  | % |
| Savings accounts                    | 11,828,752    | 2.34   | % | 10,538,023    | 2.11   | % |
| Time deposits of \$100,000 and over | 141,987,439   | 28.12  | % | 140,846,619   | 28.23  | % |
| Other time deposits                 | 176,898,277   | 35.03  | % | 183,143,150   | 36.70  | % |
| Total                               | \$504,959,317 | 100.00 | % | \$499,012,193 | 100.00 | % |

Note 7 – Trust preferred securities

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, \$5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at March 31, 2011 was 2.45%. The securities were redeemable at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. No amounts have been redeemed at March 31, 2011 and there are no plans to do so. The principal asset of the Trust is \$5.2 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

During the third quarter of 2007, Village Financial Statutory Trust II, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On September 20, 2007, \$3.6 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a five year fixed income rate of 6.29% payable quarterly, converting after five years to a LIBOR-indexed floating rate of interest (three-month LIBOR plus 1.40%) which adjusts, and is also payable, quarterly. The securities may be redeemed at par at any time commencing in December 2012 until the securities mature in 2037. The principal asset of the Trust is \$3.6 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion. The portion of the Trust Preferred Capital Notes not considered as Tier 1 capital may be included in Tier 2 capital.

The obligations of the Company with respect to the issuance of the Trust Preferred Capital Notes constitute a full and unconditional guarantee by the Company of the Trust's obligations with respect to the Trust Preferred Capital Notes. Subject to certain exceptions and limitations, the Company may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related Trust Preferred Capital Notes and require a deferral of common dividends.

Note 8 – Stock incentive plan

The Company has a stock incentive plan which authorizes the issuance of up to 455,000 shares of common stock to assist the Company in recruiting and retaining key personnel.

The following table summarizes stock options outstanding under the stock incentive plan at the indicated dates:



|  | Three Months Ended March 31, |                                 |                      |                 |         |                                 |                      |                 |
|--|------------------------------|---------------------------------|----------------------|-----------------|---------|---------------------------------|----------------------|-----------------|
|  | 2011                         |                                 |                      |                 | 2010    |                                 |                      |                 |
|  | Options                      | Weighted Average Exercise Price | Fair Value Per Share | Intrinsic Value | Options | Weighted Average Exercise Price | Fair Value Per Share | Intrinsic Value |
| Options outstanding, beginning of period | 310,205                      | \$9.48                          | \$4.73               |                 | 336,005 | \$9.58                          | \$4.75               |                 |
| Granted                                  | -                            | -                               | -                    |                 | -       | -                               | -                    |                 |
| Forfeited                                | -                            | -                               | -                    |                 | -       | -                               | -                    |                 |
| Exercised                                | -                            | -                               | -                    |                 | -       | -                               | -                    |                 |
| Options outstanding, end of period       | 310,205                      | \$9.48                          | \$4.73               | \$-             | 336,005 | \$9.58                          | \$4.75               | \$-             |
| Options exercisable, end of period       | 291,350                      |                                 |                      |                 | 300,650 |                                 |                      |                 |

During the first quarter of 2009, the Company granted to certain officers 26,592 restricted shares of common stock with a weighted average fair market value of \$4.60 at the date of grant. These restricted stock awards have three-year graded vesting. Prior to vesting, these shares are subject to forfeiture to us without consideration upon termination of employment under certain circumstances. The total number of shares underlying non-vested restricted stock and performance share awards was 8,959 and 18,078 at March 31, 2011 and 2010, respectively.

The fair value of the stock is calculated under the same methodology as stock options and the expense is recognized over the vesting period. Unamortized stock-based compensation related to nonvested share based compensation arrangements granted under the Incentive Plan as of March 31, 2010 and 2009 was \$95,176 and \$212,869 respectively. The time based unamortized compensation of \$95,176 is expected to be recognized over a weighted average period of 0.82 years.

Stock-based compensation expense was \$29,612 and \$34,044 for the three months ended March 31, 2011 and 2010, respectively.

#### Note 9 — Fair value

Effective January 1, 2008, the Company adopted the provisions of FASB Codification Topic 820: Fair Value Measurements which defines fair value, establishes a framework for measuring fair value under U.S. GAAP, and expands disclosures about fair value measurements.

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the

measurement date to allow for marketing activities that are usual and customary for transaction involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are independent, knowledgeable, able to transact and willing to transact.

FASB Codification Topic 820: Fair Value Measurements and Disclosures establishes a hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair values hierarch is as follows:

- Level 1 Inputs — Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2 Inputs — Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3 Inputs- Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods to determine the fair value of each type of financial instrument:

Investment securities: The fair values for investment securities held-to-maturity and available-for-sale is estimated based on quoted prices for similar assets or liabilities determined by bid quotation received from independent pricing services (Levels 1 and 2).

Residential loans held for sale: The fair value of loans held for sale is determined using quoted prices for a similar asset, adjusted for specific attributes of that loan (Level 2).

Impaired loans: The fair values of impaired loans are measured for impairment using the fair value of the collateral for collateral-dependent loans on a nonrecurring basis. 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 an income or market valuation approach based on an appraisal 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 two years old, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal if deemed significant using observable market data. Likewise, values for inventory and account receivables collateral are based on financial statement balances or aging reports (Level 3). Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Real Estate Owned: Real estate owned assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, real estate owned assets are carried at net realizable value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring level 3.

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Assets and liabilities measured at fair value under Topic 820 on a recurring and non-recurring basis are summarized below for the indicated dates:

|   | Carrying Value | Fair Value Measurement at March 31, 2011 Using (in thousands)  |                                   |   |
|---|----------------|--|-----------------------------------|---|
|   |                | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets - Recurring</b>     |                |  |                                   |   |
| US Treasuries                           | \$35,949       | \$35,949   | \$-                               | \$ -                                      |
| US Government Agencies                  | 5,888          | -  | 5,888                             | -   |
| MBS                                     | 33,025         | -  | 33,025                            | -   |
| Municipals                              | 5,769          | -  | 5,769                             | -   |
| Other available for sale(1)             | 1,179          | -  | 1,179                             | -   |
| <b>Financial Assets - Non-Recurring</b> |                |  |                                   |   |
| Impaired loans                          | 17,568         | -  | 9,167                             | 8,401                                     |
| Real estate owned                       | 13,505         | -  | -                                 | 13,505                                    |
| Residential loans held for sale         | 8,630          | -  | 8,630                             | -   |
| <br>                                    |                |  |                                   |   |
|   | Carrying Value | Fair Value Measurement at March 31, 2010 Using (in thousands)  |                                   |   |
|   |                | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets - Recurring</b>     |                |  |                                   |   |
| US Government Agencies                  | \$33,385       | \$-  | \$33,385                          | \$ -                                      |
| MBS                                     | 3,903          | -  | 3,903                             | -   |
| Municipals                              | 2,110          | -  | 1,027                             | -   |
| Other available for sale(1)             | 1,970          | -  | 1,970                             | -   |
| <b>Financial Assets - Non-Recurring</b> |                |  |                                   |   |
| Impaired loans                          | 33,255         | -  | -                                 | 33,255                                    |
| Real estate owned                       | 10,715         | -  | -                                 | 11,279                                    |
| Residential loans held for sale         | 10,525         | -  | 10,525                            | -   |

(1) Excludes restricted stock.

In general, fair value of securities is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon market prices determined by an outside, independent entity that primarily uses as inputs, observable market-based parameters. Fair value of loans held for sale is based upon internally developed models that primarily use as inputs, observable market-based parameters.

The following table presents the changes in the Level 3 fair value category for the period ended March 31, 2011.

|  | Impaired<br>Loans | Real Estate<br>Owned<br>(in thousands) | Total Assets |
|--|-------------------|--|--------------|
| Balance at December 31, 2010                 | \$ 8,401          | \$ 12,028                              | \$ 20,429    |
| Total realized and unrealized gains (losses) |                   |  |              |
| Included in earnings                         | -                 | 6                                      | 6            |
| Included in other comprehensive income       | -                 | -                                      | -            |
| Net transfers in and/or out of Level 3       | 9,167             | 1,471                                  | 10,638       |
| Balance at March 31, 2011                    | \$ 17,568         | \$ 13,505                              | \$ 31,073    |

Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly and or quarter valuation process.

Cash and cash equivalents – The carrying amount of cash and cash equivalents approximates fair value.

Investment securities – The fair value of investment securities available-for-sale is estimated based on bid quotations received from independent pricing services for similar assets. The carrying amount of other investments approximates fair value.

Loans – For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. For all other loans, fair values are calculated by discounting the contractual cash flows using estimated market discount rates which reflect the credit and interest rate risk inherent in the loans, or by using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Deposits – The fair value of deposits with no stated maturity, such as demand, interest checking and money market, and savings accounts, is equal to the amount payable on demand at year-end. The fair value of certificates of deposit is based on the discounted value of contractual cash flows using the rates currently offered for deposits of similar remaining maturities.

Borrowings – The fair value of borrowings is based on the discounted value of contractual cash flows using the rates currently offered for borrowings of similar remaining maturities.

Accrued interest – The carrying amounts of accrued interest receivable and payable approximate fair value.

Off-balance-sheet instruments –The fair value of off-balance-sheet lending commitments is equal to the amount of commitments outstanding at March 31, 2011 of \$70,662,000. This is based on the fact that the Bank generally does not offer lending commitments or standby letters of credit to its customers for long periods, and therefore, the underlying rates of the commitments approximate market rates.

|  | March 31,<br>2011 |                         | December 31,<br>2010 |                         |
|--|-------------------|-------------------------|----------------------|-------------------------|
|  | Carrying<br>Value | Estimated<br>Fair Value | Carrying<br>Value    | Estimated<br>Fair Value |
| <b>Financial assets</b>                  |                   |                         |                      |                         |
| Cash and cash equivalents                | \$21,516,274      | \$21,516,274            | \$12,012,311         | \$12,012,311            |
| Investment securities available for sale | 81,810,230        | 81,810,230              | 53,597,174           | 53,597,174              |
| Loans held for sale                      | 8,629,602         | 8,629,602               | 19,871,787           | 19,871,787              |
| Loans                                    | 435,952,207       | 441,171,086             | 446,555,089          | 451,155,101             |
| Accrued interest receivable              | 2,536,961         | 2,536,961               | 2,347,211            | 2,347,211               |
| <b>Financial liabilities</b>             |                   |                         |                      |                         |
| Deposits                                 | 504,959,317       | 506,940,411             | 499,012,193          | 501,222,836             |
| FHLB borrowings                          | 38,750,000        | 38,996,062              | 28,750,000           | 28,883,669              |
| Trust preferred securities               | 8,764,000         | 8,764,000               | 8,764,000            | 8,764,000               |
| Other borrowings                         | 5,241,499         | 5,241,499               | 4,165,430            | 4,165,430               |
| Accrued interest payable                 | 454,712           | 454,712                 | 404,801              | 404,801                 |

#### Note 10 – Capital Purchase Program

On May 1, 2009, as part of the Capital Purchase Program established by the U.S. Department of the Treasury (the “Treasury”) under the Emergency Economic Stabilization Act of 2008 (“EESA”), the Company entered into a Letter Agreement and Securities Purchase Agreement—Standard Terms (collectively, the “Purchase Agreement”) with the Treasury, pursuant to which the Company sold (i) 14,738 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$4.00 per share, having a liquidation preference of \$1,000 per share (the “Preferred Stock”) and (ii) a warrant (the “Warrant”) to purchase 499,029 shares of the Company’s common stock at an initial exercise price of \$4.43 per share, subject to certain anti-dilution and other adjustments, for an aggregate purchase price of \$14,738,000 in cash. The fair value of the preferred stock was estimated using discounted cash flow methodology at an assumed market equivalent rate of 13%, with 20 quarterly payments over a five year period. The fair value of the warrant was estimated using the Black-Scholes option pricing model, with assumptions of 25% volatility, a risk-free rate of 2.03%, a yield of 6.162% and an estimated life of 5 years. The value attributed to the warrant is being accreted as a discount on the preferred stock using the effective interest rate method over five years.

The Preferred Stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years, and thereafter at a rate of 9% per annum. The Preferred Stock is generally non-voting, other than on certain matters that could adversely affect the Preferred Stock.

The Warrant is immediately exercisable. The Warrant provides for the adjustment of the exercise price and the number of shares of common stock issuable upon exercise pursuant to customary anti-dilution provisions, such as upon stock splits or distributions of securities or other assets to holders of common stock, and upon certain issuances of common stock at or below a specified price relative to the then-current market price of common stock. The Warrant expires ten years from the issuance date. Pursuant to the Purchase Agreement, the Treasury has agreed not to exercise voting power with respect to any shares of common stock issued upon exercise of the Warrant.

#### Note 11 – Commitments and contingencies

Memorandums of Understanding – In December 2010, the Bank entered into a Memorandum of Understanding with the Federal Deposit Insurance Corporation (“FDIC”) and the Virginia Bureau of Financial Institutions (the “BFI”); in February 2011, the Company entered into an additional Memorandum of Understanding with the Federal Reserve and the BFI. Among other things, the Memorandums of Understanding require us to develop and submit plans to reduce improve our loan portfolio, reducing our commercial real estate concentration, maintain an appropriate allowance for loan losses, review our management performance, and correct certain violations of law. In particular, the Company must take corrective action regarding the Company’s sale of its headquarters building at the Watkins Centre to the Bank, which the Reserve Bank has determined was not permitted under Section 23A of the Federal Reserve Act. This transaction had allowed the Company to repay the outstanding mortgage loan on the building, thereby reducing interest expense and increasing earnings on a consolidated basis; as a result, any corrective action could have an adverse impact on the Company’s results of operations. The Company has provided a plan to the Federal Reserve which provides that the Company will seek to borrow funds to repurchase the building or effect a sale lease-back transaction with a third party, but cannot know at this time what corrective measure will be taken or what the impact will be. In addition, the Memorandums of Understand require us to limit asset growth to no more than 5% per year and maintain certain capital ratios higher than those required to be considered “well capitalized.” The Company has also agreed not to declare or pay and dividends on common stock or preferred stock, including the TARP preferred, or make any payments on its trust preferred securities.

While subject to the Memorandums of Understanding, we expect that our management and board of directors will be required to focus considerable time and attention on taking corrective actions to comply with the terms. In addition, certain provisions of the Memorandums of Understanding described above could adversely impact the Company’s businesses and results of operations.

There is also no guarantee that we will successfully address our regulators’ concerns in the Memorandums of Understanding or that we will be able to comply with it. If we do not comply with the Memorandums of Understanding, we could be subject to further regulatory enforcement actions.

#### Note 12 – Recent accounting pronouncements

In January 2010, the FASB issued ASU No. 2010-06- Fair Value Measurements and Disclosures amending Topic 820. The ASU provides for additional disclosures of transfers between assets and liabilities valued under Level 1 and 2 inputs as well as additional disclosures regarding those assets and liabilities valued under Level 3 inputs. The new disclosures are effective for interim and annual reporting periods beginning after December 15, 2009 except for those provisions addressing Level 3 fair value measurements which provisions are effective for fiscal years, and periods therein, beginning after December 15, 2010. The adoption of this Statement did not have a material impact on the Company’s consolidated financial statements.



In July 2010, The FASB issued ASU No. 2010-20, Receivables - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, Topic 830. This ASU requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 will be effective for the Company's consolidated financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period are required for the Company's consolidated financial statements that include periods beginning on or after January 1, 2011. This ASU required additional disclosures only and did not have an impact on the Company's consolidated financial statements.

In January 2011, the FASB issued ASC Update 2011-01 Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20. This update temporarily delays the effective date of the disclosures about troubled debt restructuring postponed the effective date of the disclosures about troubled debt restructuring in ASU 2010-20 for public companies. The delay is intended to allow FASB to complete its deliberations on what constitutes a troubled debt restructuring. The guidance on both disclosures about troubled debt restructuring and determining what constitutes a troubled debt restructuring will be coordinated and is anticipated to be issued for interim and annual periods after June 15, 2011.

In April 2011, The FASB issued ASU No. 2011-02, Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 will be effective for the Company on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. Adoption of ASU 2011-02 is not expected to have a significant impact on the Company's consolidated financial statements.

## ITEM 2 – MANAGEMENT’S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### Caution about forward-looking statements

In addition to historical information, this report may contain forward-looking statements. For this purpose, any statement, that is not a statement of historical fact may be deemed to be a forward-looking statement. These forward-looking statements may include statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy and financial and other goals. Forward-looking statements often use words such as “believes,” “expects,” “plans,” “may,” “will,” “should,” “projects,” “contemplates,” “anticipates,” “forecasts” or other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, and actual results could differ materially from historical results or those anticipated by such statements.

There are many factors that could have a material adverse effect on the operations and future prospects of the Company including, but not limited to:

- the risks of changes in interest rates on levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities;
- changes in assumptions underlying the establishment of allowances for loan losses, and other estimates;
- changes in market conditions, specifically declines in the residential and commercial real estate market, volatility and disruption of the capital and credit markets, soundness of other financial institutions we do business with;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- changes in operations of Village Bank Mortgage Corporation as a result of the activity in the residential real estate market;
- legislative and regulatory changes, including the Financial Reform Act and other changes in banking, securities, and tax laws and regulations and their application by our regulators, and changes in scope and cost of FDIC insurance and other coverages;
- exposure to repurchase loans sold to investors for which borrowers failed to provide full and accurate information on or related to their loan application or for which appraisals have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor;
- the effects of future economic, business and market conditions;
- governmental monetary and fiscal policies;
- changes in accounting policies, rules and practices;
- maintaining capital levels adequate to remain well capitalized;
- reliance on our management team, including our ability to attract and retain key personnel;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- demand, development and acceptance of new products and services;
- problems with technology utilized by us;
- changing trends in customer profiles and behavior; and
- other factors described from time to time in our reports filed with the SEC.

These risks and uncertainties should be considered in evaluating the forward-looking statements contained herein, and readers are cautioned not to place undue reliance on such statements. Any forward-looking statement speaks only as of the date on which it is made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which it is made. In addition, past results of operations are not necessarily indicative of future results.



## General

The Company was organized under the laws of the Commonwealth of Virginia as a bank holding company whose activities consist of investment in its wholly-owned subsidiary, the Bank. The Bank is engaged in commercial and retail banking. We opened to the public on December 13, 1999. We place special emphasis on serving the financial needs of individuals, small and medium sized businesses, entrepreneurs, and professional concerns.

The Bank has one subsidiary, Village Bank Mortgage Corporation. We offer a wide range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, and commercial, real estate and consumer loans. We are a community-oriented and locally owned and managed financial institution focusing on providing a high level of responsive and personalized services to our customers, delivered in the context of a strong direct relationship with the customer. We conduct our operations from our main office/corporate headquarters location and fourteen branch offices.

The Company's primary source of earnings is net interest income, and its principal market risk exposure is interest rate risk. The Company is not able to predict market interest rate fluctuations and its asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on the Company's results of operations and financial condition.

Although management endeavors to minimize the credit risk inherent in the Company's loan portfolio, it must necessarily make various assumptions and judgments about the collectability of the loan portfolio based on its experience and evaluation of economic conditions. If such assumptions or judgments prove to be incorrect, the current allowance for loan losses may not be sufficient to cover loan losses and additions to the allowance may be necessary, which would have a negative impact on net income. Over the last two years, the Company has recorded record provisions for loan losses due primarily to loans collateralized by real estate located in its principal market area.

There is intense competition in all areas in which the Company conducts its business. The Company competes with banks and other financial institutions, including savings and loan associations, savings banks, finance companies, and credit unions. Many of these competitors have substantially greater resources and lending limits and provide a wider array of banking services. To a limited extent, the Company also competes with other providers of financial services, such as money market mutual funds, brokerage firms, consumer finance companies and insurance companies. Competition is based on a number of factors, including prices, interest rates, services, availability of products and geographic location.

Although we were profitable for the year ended December 31, 2010, and the first quarter of 2011, a continuation of the turbulence in significant portions of the global financial markets, particularly if it worsens, could further impact the Company's performance, both directly by affecting revenues and the value of the Company's assets and liabilities, and indirectly by affecting the Company's counterparties and the economy generally. Dramatic declines in the housing market in the past year have resulted in significant write-downs of asset values by financial institutions in the United States. Concerns about the stability of the U.S. financial markets generally have reduced the availability of funding to certain financial institutions, leading to a tightening of credit, reduction of business activity, and increased market volatility. It is not clear at this time what impact liquidity and funding initiatives of the Treasury and other bank regulatory agencies that have been announced or any additional programs that may be initiated in the future will have on the financial markets and the financial services industry. The extreme levels of volatility and limited credit availability currently being experienced could continue to affect the U.S. banking industry and the broader U.S. and global economies, which would have an effect on all financial institutions, including the Company.

For the three months ended March 31, 2011, the Company had net income totaling \$83,000 and a net loss available to common shareholders of \$(135,000), or \$(0.03) per fully diluted share, compared to net income of \$488,000 and net income available to common shareholders of \$270,000, or \$0.06 per fully diluted basis, for the same period in 2010. The key factors in the decline in earnings were increases in the provision for loan losses of \$503,000, from \$500,000 for the first quarter of 2010 to \$1,003,000 for the first quarter of 2011, and the expenses associated with foreclosed real estate, which increased by \$252,000 from \$210,000 for the first quarter of 2010 to \$462,000 at March 31, 2011. While the recessionary economy continues to negatively impact our earnings in 2011, the first quarter of 2011 represents the fifth consecutive quarter that the Company has recorded net income.

Our total assets increased to \$608,263,000 at March 31, 2011 from \$591,779,000 at December 31, 2010, an increase of \$16,484,000, or 2.8%. During the first quarter of 2011 liquid assets (cash and due from banks, federal funds sold and investment securities available for sale) increased by \$37,717,000, loans held for sale decreased by \$11,242,000, net portfolio loans decreased by \$10,603,000, and other real estate owned increased by \$1,477,000. The net increase in total assets of \$16,484,000 was funded by a \$5,947,000 increase in deposit accounts and an increase in borrowings of \$11,076,000.

The following presents management's discussion and analysis of the financial condition of the Company at March 31, 2011 and December 31, 2010, and results of operations for the Company for the three month periods ended March 31, 2011 and 2010. This discussion should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2010 as filed with the Securities and Exchange Commission as well as the first quarter 2011 financial statements and notes thereto appearing elsewhere in this report.

#### Results of operations

For the three months ended March 31, 2011, the Company had net income totaling \$83,000, and a net loss available to common shareholders of \$(135,000), or \$(0.03) per fully diluted share, compared net income of \$488,000 and net income available to common shareholders of \$270,000, or \$0.06 per fully diluted share, for the same period in 2010. This represents a decline in net income of \$405,000.

The decrease in net income for the quarter ended March 31, 2011 compared to the same period in 2010 is attributable primarily to an increase in the provision for loan losses as well as an increase in expenses related to foreclosed assets. These increases in 2011 reflect the continued stress on our borrowers and real estate values from the recessionary economy. Asset quality continues to be a concern as there continues to be uncertainty in the economy. The increase in the provision for loan losses is discussed further under Asset quality and provision for loan losses.

Our cost of deposits declined from 2.18% for the first quarter of 2010 to 1.81% for the first quarter of 2011. This decline in cost of deposits is a result of the repricing of higher cost certificates of deposit during the low interest rate environment that has existed for the last two years as well as an effort to change our deposit mix so that we are not so dependent on higher cost deposits. Our mortgage company's profit declined in the first quarter of 2011 compared to 2010 by \$89,000 due to the mortgage company closing \$42,899,000 in mortgage loans in the first quarter of 2011 compared to \$50,901,000 in the first quarter of 2010.

## Net interest income

Net interest income is our primary source of earnings and represents the difference between interest and fees earned on interest-earning assets and the interest paid on interest-bearing liabilities. The level of net interest income is affected primarily by variations in the volume and mix of those assets and liabilities, as well as changes in interest rates when compared to previous periods of operation.

Net interest income for the first quarter of \$5,038,000 represents an increase of \$622,000, or 14%, compared to the first quarter of 2010, and a decrease of \$100,000, or 2%, compared to the fourth quarter of 2010. The increase in net interest income from the first quarter of 2010 to the first quarter in 2011 is a result of a decline in the Company's cost of funds, which declined from 2.36% for the first quarter of 2010 to 1.86% for the first quarter of 2011. The decrease in net interest income from the fourth quarter is a result of a strategic shift in our interest-earning assets from loans to investment securities and federal funds sold to increase liquidity. Yields on loans are generally higher than yields on more liquid assets such as investment securities and federal funds sold.

The Company's net interest margin is not a measurement under accounting principles generally accepted in the United States, but it is a common measure used by the financial services industry to determine how profitably earning assets are funded. Net interest margin is calculated by dividing net interest income by average earning assets. Our net interest margin over the last several quarters is provided in the following table:

| Quarter Ended      |       |
|--------------------|-------|
| December 31, 2009  | 3.18% |
| March 31, 2010     | 3.26% |
| June 30, 2010      | 3.46% |
| September 30, 2010 | 3.74% |
| December 31, 2010  | 3.84% |
| March 31, 2011     | 3.79% |

As interest rates were reduced by the Federal Reserve during 2007 and 2008 in reaction to the declining economy, our margin was compressed as our deposits generally do not reprice as quickly as our loans. As our deposits repriced downward and the yield on interest earning assets stabilized, our net interest margin reflected an upward trend. However, given the continued depressed economy and the potential impact on interest income from new nonaccrual loans, no assurance can be provided that this will continue to occur. The small decline in the net interest margin from the fourth quarter of 2010 to the first quarter of 2011 is a result of the strategic shift in our interest-earning assets from loans to investment securities and federal funds sold noted previously.

Average interest-earning assets for the first quarter of 2011 decreased by \$10,681,000, or 2%, compared to the first quarter of 2010. The decrease in interest-earning assets was due primarily to a decrease in portfolio loans of \$20,148,000 offset by increases in loans held for sale of \$1,598,000 and federal funds sold of \$7,230,000. The average yield on interest-earning assets increased to 5.54% for the first quarter of 2011 compared to 5.51% for the first quarter of 2010. Many of our loans are indexed to short-term rates affected by the Federal Reserve's decisions about short-term interest rates, and, accordingly, as the Federal Reserve increases or decreases short-term rates, the yield on interest-earning assets is affected. Additionally, while many of our indexed rate loans have interest rate floors included in their terms, we have decreased rates to loan customers to better reflect the current interest rate environment and, in some limited cases, to facilitate workouts on nonperforming loans.

Our average interest-bearing liabilities decreased by \$16,200,000, or 3%, for the first quarter of 2011 compared to the first quarter of 2010. The decrease in interest-bearing liabilities was due to declines in average deposits of \$9,513,000 and other borrowings of \$6,687,000. The average cost of interest-bearing liabilities decreased to 1.86% for the first three months of 2011 from 2.36% for the first quarter of 2010. The principal reason for the decrease in liability costs was the reduction in short-term interest rates by the Federal Reserve. See our discussion of interest rate sensitivity below for more information.

The following table illustrates average balances of total interest-earning assets and total interest-bearing liabilities for the periods indicated, showing the average distribution of assets, liabilities, shareholders' equity and related income, expense and corresponding weighted-average yields and rates. The average balances used in these tables and other statistical data were calculated using daily average balances. We had no tax exempt assets for the periods presented.



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Average Balance Sheets  
(In thousands)

|   | Three Months Ended March 31, 2011 |                         |                       |   | Three Months Ended March 31, 2010 |                         |                       |   |
|---|-----------------------------------|-------------------------|-----------------------|---|-----------------------------------|-------------------------|-----------------------|---|
|   | Average Balance                   | Interest Income/Expense | Annualized Yield Rate |   | Average Balance                   | Interest Income/Expense | Annualized Yield Rate |   |
| Loans   | \$449,528                         | \$6,919                 | 6.24                  | % | \$469,676                         | \$7,000                 | 6.04                  | % |
| Investment securities   | 46,919                            | 300                     | 2.59                  | % | 46,280                            | 357                     | 3.13                  | % |
| Loans held for sale   | 8,806                             | 122                     | 5.62                  | % | 7,208                             | 89                      | 5.01                  | % |
| Federal funds and other   | 33,456                            | 18                      | 0.22                  | % | 26,226                            | 14                      | 0.22                  | % |
| Total interest earning assets   | 538,709                           | 7,359                   | 5.54                  | % | 549,390                           | 7,460                   | 5.51                  | % |
| Allowance for loan losses and deferred fees   | (7,308 )                          |                         |                       |   | (10,582 )                         |                         |                       |   |
| Cash and due from banks   | 8,500                             |                         |                       |   | 12,031                            |                         |                       |   |
| Premises and equipment, net   | 27,454                            |                         |                       |   | 27,774                            |                         |                       |   |
| Other assets  | 32,483                            |                         |                       |   | 34,324                            |                         |                       |   |
| Total assets  | \$599,838                         |                         |                       |   | \$612,937                         |                         |                       |   |
| Interest bearing deposits   |                                   |                         |                       |   |                                   |                         |                       |   |
| Interest checking   | \$33,402                          | \$63                    | 0.76                  | % | \$37,222                          | \$135                   | 1.47                  | % |
| Money market  | 92,997                            | 203                     | 0.89                  | % | 111,145                           | 370                     | 1.35                  | % |
| Savings   | 11,239                            | 20                      | 0.72                  | % | 9,391                             | 26                      | 1.12                  | % |
| Certificates  | 319,826                           | 1,752                   | 2.22                  | % | 309,218                           | 1,980                   | 2.60                  | % |
| Total   | 457,464                           | 2,038                   | 1.81                  | % | 466,976                           | 2,511                   | 2.18                  | % |
| Borrowings  | 48,547                            | 283                     | 2.36                  | % | 55,234                            | 534                     | 3.92                  | % |
| Total interest bearing liabilities  | 506,011                           | 2,321                   | 1.86                  | % | 522,210                           | 3,045                   | 2.36                  | % |
| Noninterest bearing deposits  | 44,234                            |                         |                       |   | 38,001                            |                         |                       |   |
| Other liabilities   | 1,730                             |                         |                       |   | 3,430                             |                         |                       |   |
| Total liabilities   | 551,975                           |                         |                       |   | 563,641                           |                         |                       |   |
| Equity capital  | 47,864                            |                         |                       |   | 49,297                            |                         |                       |   |
| Total liabilities and capital   | \$599,839                         |                         |                       |   | \$612,938                         |                         |                       |   |
| Net interest income before provision for L/L  |                                   | \$5,038                 |                       |   |                                   | \$4,415                 |                       |   |
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities |                                   |                         | 3.68                  | % |                                   |                         | 3.15                  | % |

Annualized net interest margin  
(net  
interest income expressed as  
percentage of average earning  
assets)

3.79 %

3.26 %

Asset quality and provision for loan losses

Provisions for loan losses amounted to \$1,003,000 for the three months ended March 31, 2011 compared to \$500,000 for the first quarter of 2010. The increase in the provision for loan losses in 2011 reflects the continued stress on our borrowers from the recessionary economy. Asset quality continues to be a concern as there continues to be uncertainty in the economy. However, our nonaccrual loans continue to decrease which is a positive indicator of improving asset quality.

Nonperforming assets consisting of nonaccrual loans and other real estate owned for the indicated periods is as follows (dollars in thousands):

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|                            | March 31,<br>2011 | Dec 31,<br>2010 | Sept 30,<br>2010 | June 30,<br>2010 | March 31,<br>2010 |
|----------------------------|-------------------|-----------------|------------------|------------------|-------------------|
| Nonaccrual loans           |                   |                 |                  |                  |                   |
| Number                     | 97                | 106             | 117              | 132              | 130               |
| Amount                     | \$ 17,568         | \$ 20,324       | \$ 23,943        | \$ 31,106        | \$ 33,255         |
| Other real estate owned    | 13,505            | 12,028          | 12,941           | 11,816           | 10,715            |
| Nonperforming assets       | \$ 31,073         | \$ 32,352       | \$ 36,884        | \$ 42,922        | \$ 43,970         |
| Percentage of total assets | 5.11 %            | 5.47 %          | 6.32 %           | 7.08 %           | 7.14 %            |

The continued decrease in nonperforming assets in the first quarter of 2011 reflects the focus of management on this effort as well as placing a few loans back on accrual status. The \$31,073,000 in nonperforming assets at March 31, 2011 represents a decline of \$12,897,000, or 29%, from the amount one year earlier. Loans may be placed back on accrual status when, in the opinion of management, the circumstances warrant such action such as a history of timely payments, additional collateral is obtained or the borrowers cash flows improve. Our approach to troubled lending relationships is to work with the borrower to the extent possible and still adhere to strong credit management guidelines. If the economy continues to be depressed at the levels we have experienced from the latter part of 2008 through 2010, nonperforming assets could continue to increase. See our discussion of the allowance for loan losses under Allowance for loan losses and Critical accounting policies below.

In addition to the nonperforming assets at March 31, 2011, there were eight loans past due 90 days or more totaling \$440,000 and still accruing interest, compared to six loans totaling \$315,000 at December 31, 2010. We believe that these assets are adequately collateralized and are currently recorded at realistically recoverable values. However, economic circumstances related to specific credit relationships are changing, which may impact our assessments of collectability.

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The following table reflects details related to asset quality and allowance for loan losses of Village Bank (dollars in thousands):

|  | Mar 31,<br>2011 | Dec 31,<br>2010 | Sept 30,<br>2010 | June 30,<br>2010 | Mar 31,<br>2010 |
|--|-----------------|-----------------|------------------|------------------|-----------------|
| Loans 90 days past due and still accruing                  | \$ 440          | \$ 315          | \$ 738           | \$ 959           | \$ 2,535        |
| Restructured loans   | 25,932          | 21,695          | 21,703           | 16,722           | 16,737          |
| Nonaccrual loans   | 17,568          | 20,324          | 23,943           | 31,106           | 33,255          |
| Other real estate owned                                    | 13,505          | 12,028          | 12,941           | 11,816           | 10,715          |
| Allowance for loan losses                                  |                 |                 |                  |                  |                 |
| Beginning balance  | \$ 7,312        | \$ 9,819        | \$ 9,500         | \$ 9,091         | \$ 10,522       |
| Provision for loan losses                                  | 1,003           | 1,692           | 1,410            | 1,240            | 500             |
| Charge-offs  | (883 )          | (4,207 )        | (1,091 )         | (954 )           | (2,114 )        |
| Recoveries   | 2               | 8               | -                | 123              | 183             |
| Ending balance   | \$ 7,434        | \$ 7,312        | \$ 9,819         | \$ 9,500         | \$ 9,091        |
| Ratios   |                 |                 |                  |                  |                 |
| Allowance for loan losses to Loans, net of unearned income | 1.68 %          | 1.61 %          | 2.14 %           | 2.05 %           | 1.96 %          |
| Nonaccrual loans   | 42.32 %         | 35.98 %         | 41.01 %          | 30.54 %          | 27.34 %         |
| Nonperforming assets to total assets                       | 5.11 %          | 5.47 %          | 6.32 %           | 7.08 %           | 7.14 %          |

#### Noninterest income

Noninterest income decreased from \$2,154,000 for the three months ended March 31, 2010 to \$2,055,000 for the same period in 2011, a decrease of \$99,000, or 5%. This decrease in noninterest income is primarily a result of a gain on the sale of land behind one of our branches in 2010 of \$244,000.

#### Noninterest expense

Noninterest expense increased by \$567,000 from the first quarter of 2010 to the first quarter of 2011. The more significant increases in noninterest expense occurred in salaries and benefits of \$283,000 and expenses related to foreclosed real estate of \$252,000. The increase in salaries is attributable to promotional raises, an increase in the cost of benefits and a decline of \$151,000 in the amount of capitalized salary cost related to the origination of loans.

#### Income taxes

The provision for income taxes of \$109,000 for the three months ended March 31, 2011 is based upon the results of operations. Certain items of income and expense are reported in different periods for financial reporting and tax return purposes. The tax effects of these temporary differences are recognized currently in the deferred income tax provision or benefit. Deferred tax assets or liabilities are computed based on the difference between the financial statement and income tax bases of assets and liabilities using the applicable enacted marginal tax rate.

The Company must also evaluate the likelihood that deferred tax assets will be recovered from future taxable income. If any such assets are not likely to be recovered, a valuation allowance must be recognized. We determined that a valuation allowance was not required for deferred tax assets as of March 31, 2011. The assessment of the carrying value of deferred tax assets is based on certain assumptions, changes in which could have a material impact on the Company's financial statements.

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Company recorded a franchise tax expense of \$85,000 and \$95,000 for the three months ended March 31, 2011 and 2010, respectively.

## Loans

A management objective is to maintain the quality of the loan portfolio. The Company seeks to achieve this objective by maintaining rigorous underwriting standards coupled with regular evaluation of the creditworthiness of and the designation of lending limits for each borrower. The portfolio strategies include seeking industry and loan size diversification in order to minimize credit exposure and originating loans in markets with which the Company is familiar.

The Company's real estate loan portfolios, which represent approximately 91% of all loans, are secured by mortgages on real property located principally in the Commonwealth of Virginia. Sources of repayment are from the borrower's operating profits, cash flows and liquidation of pledged collateral. The Company's commercial loan portfolio represents approximately 8% of all loans. Loans in this category are typically made to individuals, small and medium-sized businesses and range between \$250,000 and \$2.5 million. Based on underwriting standards, commercial and industrial loans may be secured in whole or in part by collateral such as liquid assets, accounts receivable, equipment, inventory, and real property. The collateral securing any loan may depend on the type of loan and may vary in value based on market conditions. The remainder of our loan portfolio is in consumer loans which represent 1% of the total.

The following table presents the composition of our loan portfolio (excluding mortgage loans held for sale) at the dates indicated.

### Loan Portfolio, Net (In thousands)

|  | March 31, 2011 |       |   | December 31, 2010 |       |   |
|--|----------------|-------|---|-------------------|-------|---|
|  | Amount         | %     |   | Amount            | %     |   |
| Commercial   | \$35,415       | 8.0   | % | \$37,228          | 8.2   | % |
| Real estate - Construction, land development & other loans | 87,933         | 19.9  | % | 90,773            | 20.0  | % |
| Real estate - Commercial                                   | 166,207        | 37.5  | % | 173,227           | 38.2  | % |
| Real estate - 1-4 Residential                              | 147,696        | 33.4  | % | 146,647           | 32.4  | % |
| Consumer   | 5,469          | 1.2   | % | 5,368             | 1.2   | % |
| Total loans  | 442,720        | 100.0 | % | 453,243           | 100.0 | % |
| Deferred loan cost (unearned income), net                  | 666            |       |   | 624               |       |   |
| Less: Allowance for loan losses                            | (7,434 )       |       |   | (7,312 )          |       |   |
| Total loans, net   | \$435,952      |       |   | \$446,555         |       |   |

The Company assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

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- Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. 1-4 assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
- Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;
- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any, and;
- Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

|   | Risk Rated<br>1-4 | Risk Rated<br>5 | Risk Rated<br>6 | Risk Rated<br>7 | Total<br>Loans |
|---|-------------------|-----------------|-----------------|-----------------|----------------|
| Commercial  | \$ 28,477,734     | \$ 2,927,082    | \$ 3,486,526    | \$ 523,868      | \$ 35,415,210  |
| Real estate - Construction, land<br>development & other loans | 59,664,988        | 3,750,564       | 24,516,852      | -               | 87,932,404     |
| Real estate - Commercial                                      | 116,749,553       | 23,635,110      | 25,629,443      | 193,251         | 166,207,357    |
| Real estate - 1-4 Residential                                 | 131,407,250       | 5,892,408       | 10,232,721      | 163,825         | 147,696,204    |
| Consumer  | 4,313,495         | 745,905         | 302,702         | 106,966         | 5,469,068      |
| Total loans   | \$ 340,613,020    | \$ 36,951,069   | \$ 64,168,244   | \$ 987,910      | \$ 442,720,243 |

The following table presents the aging of the recorded investment in past due loans and leases as of March 31, 2011:

|  | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>Than<br>90 Days | Total Past<br>Due | Current       | Total<br>Loans | Recorded<br>Investment<br>><br>90 Days<br>and<br>Accruing |
|--|------------------------|------------------------|----------------------------|-------------------|---------------|----------------|---|
| Commercial   | \$381,958              | \$381,974              | \$11,926                   | \$775,858         | \$34,639,352  | \$35,415,210   | \$11,926  |
| Real estate -<br>Construction,<br>land<br>development &<br>other loans | 4,017,664              | 196,564                | -                          | 4,214,228         | 83,718,176    | 87,932,404     | -   |
| Real estate -<br>Commercial  | 3,517,265              | 268,443                | 173,213                    | 3,958,921         | 162,248,436   | 166,207,357    | 173,213   |
| Real estate - 1-4<br>Residential                                       | 5,503,828              | 1,625,973              | 228,175                    | 7,357,976         | 140,338,228   | 147,696,204    | 228,175   |
| Consumer   | 106,659                | -                      | 26,574                     | 133,233           | 5,335,835     | 5,469,068      | 26,574  |
| Total  | \$13,527,374           | \$2,472,954            | \$439,888                  | \$16,440,216      | \$426,280,027 | \$442,720,243  | \$439,888   |

Loans are considered impaired when, based on current information and events it is probably the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Impaired loans at March 31, 2011 are set forth in the following table.



| Description of Loans   | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded Investment             |   |                      | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Average<br>Investment |
|--|---|---------------------------------|---|----------------------|--|-----------------------------------|
|  |   | Total<br>Recorded<br>Investment | Recorded<br>Investment<br>with<br>Allowance | Related<br>Allowance |  |                                   |
| Commercial   | \$3,128,283                                   | \$2,936,225                     |   | \$2,936,225          |  | \$2,342,004                       |
| Real estate - Construction,<br>land development & other<br>loans | 7,937,685                                     | 6,793,373                       | \$372,155                                   | 6,421,218            | \$50,000                                       | 5,726,924                         |
| Real estate - Commercial   | 2,032,248                                     | 1,603,604                       |   | 1,603,604            |  | 5,589,010                         |
| Real estate - 1-4 Residential                                    | 7,096,355                                     | 6,080,588                       | 236,991                                     | 5,843,597            | 41,500   | 5,153,596                         |
| Consumer   | 155,854                                       | 153,782                         | -   | 153,782              | -  | 117,295                           |
|  | \$20,350,425                                  | \$17,567,572                    | \$609,146                                   | \$16,958,426         | \$91,500                                       | \$18,928,829                      |

#### Allowance for loan losses

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. An allowance for loan losses is established through a provision for loan losses based upon an evaluation of the level of loans outstanding, the level of non-performing loans, historical loan loss experience, delinquency trends, underlying collateral values, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions.

The level of the allowance for loan losses is determined by an ongoing detailed analysis of risk and loss potential within the portfolio as a whole. Outside of our own analysis, our reserve adequacy and methodology are reviewed on a regular basis by an independent firm and bank regulators.

The overall allowance for loan losses is equivalent to 1.68% of total loans net of deferred fees. The schedule below, Analysis of Allowance for Loan Losses, reflects the pro rata allocation by the different loan types. The methodology as to how the allowance was derived is a combination of specific allocations and percentage allocations of the unallocated portion of the allowance for loan losses, as discussed below. The Company has developed a comprehensive risk weighting system based on individual loan characteristics that enables the Company to allocate the composition of the allowance for loan losses by types of loans.

The methodology as to how the allowance was derived is detailed below. Unallocated amounts included in the allowance for loan losses have been applied to the loan classifications on a percentage basis.

Adequacy of the reserve is assessed, and appropriate expense and charge-offs are taken, no less frequently than at the close of each fiscal quarter end. The methodology by which we systematically determine the amount of our reserve is set forth by the board of directors in our Loan Policy. Under this Policy, management is charged with ensuring that each loan is individually evaluated and the portfolio characteristics are evaluated to arrive at an appropriate aggregate reserve. The results of the analysis are documented, reviewed and approved by the board of directors no less than quarterly. The following elements are considered in this analysis: individual loan risk ratings, lending staff changes, loan review and board oversight, loan policies and procedures, portfolio trends with respect to volume, delinquency, composition/concentrations of credit, risk rating migration, levels of classified credit, off-balance sheet credit exposure, any other factors considered relevant from time to time (the "general reserve"); loss estimates on specific problem credits (the "specific reserve"), and, finally, an "unallocated reserve" to cover any unforeseen factors as a result of current economic conditions. Each of the reserve components, general, specific and unallocated are discussed in

further detail below.

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With respect to the general reserve, all loans are graded or “Risk Rated” individually for loss potential at the time of origination and as warranted thereafter, but no less frequently than quarterly. Loss potential factors are applied based upon a blend of the following criteria: our own direct experience; our collective management experience in administering similar loan portfolios in the market; and peer data contained in statistical releases issued by the FDIC. Management’s collective experience at this company and other banks is the most heavily weighted criterion, and the weighting is subjective and varies by loan type, amount, collateral, structure, and repayment terms. Prevailing economic conditions generally and within each individual borrower’s business sector are considered, as well as any changes in the borrower’s own financial position and, in the case of commercial loans, management structure and business operations.

When deterioration develops in an individual credit, the loan is placed on a “Watch List” and the loan is monitored more closely. All loans on the watch list are evaluated for specific loss potential based upon either an evaluation of the liquidated value of the collateral or cash flow deficiencies. If management believes that, with respect to a specific loan, an impaired source of repayment, collateral impairment or a change in a debtor’s financial condition presents a heightened risk of non-performance of a particular loan, a portion of the reserve may be specifically allocated to that individual loan. The aggregation of this loan by loan loss analysis comprises the specific reserve.

The unallocated reserve is maintained to absorb risk factors outside of the general and specific reserves. To arrive at the unallocated reserve, the loan portfolio is “shocked” or downgraded by a certain percentage based on management’s subjective assessment of the state of the economy. The current depressed economy resulted in an increase in the percentage downgrade of the loan portfolio.

The allowance for loan losses at March 31, 2011 was \$7,434,000, compared to \$7,312,000 at December 31, 2010. The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) at March 31, 2011 and December 31, 2010 was 1.68% and 1.61%, respectively. The increase in this ratio is primarily attributable to the decrease in loans from December 2010. The amount of the loan loss provision is determined by an evaluation of the level of loans outstanding, the level of non-performing loans, historical loan loss experience, delinquency trends, underlying collateral values, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions. See our discussion of the allowance for loan losses under Critical accounting policies below.

The following table presents an analysis of the changes in the allowance for loan losses for the periods indicated.

Analysis of Allowance for Loan Losses  
(in thousands)

|   | Three Months Ended<br>March 31, |   |           |   |
|---|---------------------------------|---|-----------|---|
|   | 2011                            |   | 2010      |   |
| Beginning balance   | \$7,312                         |   | \$10,522  |   |
| Provision for loan losses   | 1,003                           |   | 500       |   |
| Charge-offs   |                                 |   |           |   |
| Commercial  | (327                            | ) | (957      | ) |
| Real estate - Construction, land development & other loans                          | -                               |   | (1,034    | ) |
| Real estate - Commercial  | (474                            | ) | (4        | ) |
| Real estate - 1-4 Residential   | -                               |   | (115      | ) |
| Consumer  | (83                             | ) | (4        | ) |
|   | (884                            | ) | (2,114    | ) |
| Recoveries  |                                 |   |           |   |
| Commercial  | -                               |   | 183       |   |
| Real estate - Construction, land development & other loans                          | -                               |   | -         |   |
| Real estate - Commercial  | 2                               |   | -         |   |
| Real estate - 1-4 Residential   | 1                               |   | -         |   |
| Consumer  | -                               |   | -         |   |
|   | 3                               |   | 183       |   |
| Net charge-offs   | (881                            | ) | (1,931    | ) |
| Ending balance  | \$7,434                         |   | \$9,091   |   |
| Loans outstanding at end of year(1)   | \$443,386                       |   | \$464,105 |   |
| Ratio of allowance for loan losses as a percent of loans outstanding at end of year | 1.68                            | % | 1.96      | % |
| Average loans outstanding for the year(1)   | \$449,528                       |   | \$469,676 |   |
| Ratio of net charge-offs to average loans outstanding for the year                  | 0.20                            | % | 0.41      | % |

(1) Loans are net of unearned income.

#### Deposits

Deposits increased by \$5,947,000, or 1.2%, from \$499,012,000 at December 31, 2010 to \$504,959,000 at March 31, 2011, as compared to an increase of \$12,692,000, or 3%, during the first three months of 2010. Checking and savings accounts increased by \$9,972,000, money market accounts increased by \$1,079,000 and time deposits decreased by \$5,104,000. The cost of our interest bearing deposits declined to 1.81% for the first quarter of 2011 compared to 1.85% for the fourth quarter of 2010 and 2.18% for the first quarter of 2010.

While the mix of our deposits continues to be weighted toward time deposits, such deposits represent only 63% of total deposits at March 31, 2011 and 65% at December 31, 2010. As our branch network has increased and is more convenient to a larger segment of our targeted customer base, we have experienced a move to a higher percentage of our deposits in checking accounts. We are emphasizing checking account deposit growth at our existing branches.



The variety of deposit accounts that we offer has allowed us to be competitive in obtaining funds and has allowed us to respond with flexibility to, although not to eliminate, the threat of disintermediation (the flow of funds away from depository institutions such as banking institutions into direct investment vehicles such as government and corporate securities). Our ability to attract and retain deposits, and our cost of funds, has been, and is expected to continue to be, significantly affected by money market conditions.

#### Borrowings

We use borrowings to supplement deposits when they are available at a lower overall cost to us or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank of Atlanta (“FHLB”), the Bank is required to own capital stock in the FHLB and is authorized to apply for borrowings from the FHLB. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses to which the advances may be put, as well as on the size of the advances and repayment provisions. Borrowings from the FHLB were \$38,750,000 and \$28,750,000 at March 31, 2011 and December 31, 2010, respectively. The FHLB advances are secured by the pledge of residential mortgage loans, investment securities and our FHLB stock. Available borrowings at March 31, 2011 were approximately \$6.5 million.

#### Capital resources

Stockholders’ equity at March 31, 2011 was \$48,159,000, compared to \$48,320,000 at December 31, 2010. On May 1, 2009, the Company received a \$14,738,000 investment by the United States Department of the Treasury under its Capital Purchase Program (the TARP Program). The TARP Program is a voluntary program designed to provide capital for healthy banks to improve the flow of funds from banks to their customers. Under the TARP Program, the Company issued to the Treasury \$14,738,000 of preferred stock and warrants to purchase 499,030 shares of the Company’s common stock at a purchase price of \$4.43 per share. The preferred stock issued by the Company under the TARP Capital Purchase Program carries a 5% dividend for each of the first 5 years of the investment, and 9% thereafter, unless the shares are redeemed by the Company. The \$161,000 decrease in equity during the first three months of 2011 was primarily due to dividends paid to the U.S. Treasury on the TARP investment of \$182,000, a decrease of \$91,000 in other comprehensive income related to available for sale investments, and reduced by net income of \$83,000.

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, under capitalized, significantly under capitalized, and critically under capitalized. The Bank meets the criteria to be categorized as a “well capitalized” institution as of March 31, 2011.

During the first quarter of 2005, the Company issued \$5.2 million in Trust Preferred Capital Notes to increase its regulatory capital and to help fund its expected growth in 2005. During the third quarter of 2007, the Company issued \$3.6 million in Trust Preferred Capital Notes to partially fund the construction of an 80,000 square foot building completed in 2008. The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion.

The following table presents the composition of regulatory capital and the capital ratios at the dates indicated.

Analysis of Capital  
(in thousands)

|   | March 31,<br>2011 |   | December<br>31,<br>2010 |   |
|---|-------------------|---|-------------------------|---|
| Tier 1 capital                                    |                   |   |                         |   |
| Preferred stock                                   | \$59              |   | \$59                    |   |
| Common stock                                      | 16,974            |   | 16,954                  |   |
| Additional paid-in capital                        | 40,643            |   | 40,634                  |   |
| Retained earnings (deficit)                       | (9,328 )          |   | (9,193 )                |   |
| Warrant Surplus                                   | 732               |   | 732                     |   |
| Discount on preferred stock                       | (456 )            |   | (492 )                  |   |
| Qualifying trust preferred securities             | 8,764             |   | 8,764                   |   |
| Total equity                                      | 57,388            |   | 57,458                  |   |
| Less: goodwill                                    | -                 |   | -                       |   |
| Total Tier 1 capital                              | 57,388            |   | 57,458                  |   |
| <br>Tier 2 capital                                |                   |   |                         |   |
| Allowance for loan losses                         | 5,709             |   | 5,900                   |   |
| Total Tier 2 capital                              | 5,709             |   | 5,900                   |   |
| <br>Total risk-based capital                      | 63,097            |   | 63,358                  |   |
| <br>Risk-weighted assets                          | \$461,508         |   | \$470,662               |   |
| <br>Average assets                                | \$574,028         |   | \$596,765               |   |
| <br>Capital ratios                                |                   |   |                         |   |
| Leverage ratio (Tier 1 capital to average assets) | 10.00             | % | 9.63                    | % |
| Tier 1 capital to risk-weighted assets            | 12.43             | % | 12.21                   | % |
| Total capital to risk-weighted assets             | 13.67             | % | 13.46                   | % |
| Equity to total assets                            | 7.92              | % | 8.17                    | % |

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, under capitalized, significantly under capitalized, and critically under capitalized. The Bank meets the criteria to be categorized as a “well capitalized” institution as of March 31, 2011 and December 31, 2010. In addition, in December 2010 the Bank entered into a memorandum of understanding with the FDIC that it must maintain a leverage ratio of more than 8% and a total capital to risk-weighted assets ratio of more than 11.5%. The bank also met the criteria as of March 31, 2011. When capital falls below the “well capitalized” requirement, consequences can include: new branch approval could be withheld; more frequent examinations by the FDIC; brokered deposits cannot be renewed without a waiver from the FDIC; and other potential limitations as described in FDIC Rules and Regulations sections 337.6 and 303, and FDIC Act section 29. In addition, the FDIC insurance assessment increases when an institution falls below the “well capitalized” classification.





## Liquidity

Liquidity provides us with the ability to meet normal deposit withdrawals, while also providing for the credit needs of customers. We are committed to maintaining liquidity at a level sufficient to protect depositors, provide for reasonable growth, and fully comply with all regulatory requirements.

At March 31, 2011, cash, cash equivalents and investment securities available for sale totaled \$103,327,000, or 17% of total assets, which we believe is adequate to meet short-term liquidity needs.

At March 31, 2011, we had commitments to originate \$70,662,000 of loans as compared to \$59,240,000 at December 31, 2010. The increase is primarily attributable to commitments to make mortgage loans by our mortgage company which will be sold in the secondary market. Fixed commitments to incur capital expenditures were less than \$25,000 at March 31, 2011. Time deposits scheduled to mature in the 12-month period ending March 31, 2012 totaled \$164,400,000 at March 31, 2011. Based on past experience, we believe that a significant portion of such deposits will remain with us. We further believe that loan repayments and other sources of funds such as deposit growth will be adequate to meet our foreseeable short-term and long-term liquidity needs.

## Interest rate sensitivity

An important element of asset/liability management is the monitoring of our sensitivity to interest rate movements. In order to measure the effects of interest rates on our net interest income, management takes into consideration the expected cash flows from the securities and loan portfolios and the expected magnitude of the repricing of specific asset and liability categories. We evaluate interest sensitivity risk and then formulate guidelines to manage this risk based on management's outlook regarding the economy, forecasted interest rate movements and other business factors. Our goal is to maximize and stabilize the net interest margin by limiting exposure to interest rate changes.

Contractual principal repayments of loans do not necessarily reflect the actual term of our loan portfolio. The average lives of mortgage loans are substantially less than their contractual terms because of loan prepayments and because of enforcement of due-on-sale clauses, which gives us the right to declare a loan immediately due and payable in the event, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. In addition, certain borrowers increase their equity in the security property by making payments in excess of those required under the terms of the mortgage.

The sale of fixed rate loans is intended to protect us from precipitous changes in the general level of interest rates. The valuation of adjustable rate mortgage loans is not as directly dependent on the level of interest rates as is the value of fixed rate loans. As with other investments, we regularly monitor the appropriateness of the level of adjustable rate mortgage loans in our portfolio and may decide from time to time to sell such loans and reinvest the proceeds in other adjustable rate investments.

The data in the following table reflects repricing or expected maturities of various assets and liabilities at March 31, 2011. The gap analysis represents the difference between interest-sensitive assets and liabilities in a specific time interval. Interest sensitivity gap analysis presents a position that existed at one particular point in time, and assumes that assets and liabilities with similar repricing characteristics will reprice at the same time and to the same degree.

Village Bank and Trust Financial Corp.  
Interest Rate Sensitivity GAP Analysis  
March 31, 2011  
(in thousands)

|   | Within 3<br>Months | 3 to 6<br>Months    | 6 to 12<br>Months   | 13 to 36<br>Months   | More than<br>36 Months | Total            |
|---|--------------------|---------------------|---------------------|----------------------|------------------------|------------------|
| <b>Interest Rate Sensitive Assets</b>   |                    |                     |                     |                      |                        |                  |
| Loans (1)   |                    |                     |                     |                      |                        |                  |
| Fixed rate  | \$ 21,820          | \$ 13,206           | \$ 33,748           | \$ 35,785            | \$ 132,148             | \$ 236,707       |
| Variable rate   | 101,749            | 5,063               | 9,745               | 23,501               | 65,955                 | 206,013          |
| Investment securities   | 32,000             | -                   | 83                  | 29                   | 49,698                 | 81,810           |
| Loans held for sale   | 8,630              | -                   | -                   | -                    | -                      | 8,630            |
| Federal funds sold  | 8,751              | -                   | -                   | -                    | -                      | 8,751            |
| <b>Total rate sensitive assets</b>  | <b>172,950</b>     | <b>18,269</b>       | <b>43,576</b>       | <b>59,315</b>        | <b>247,801</b>         | <b>541,911</b>   |
| <b>Cumulative rate sensitive assets</b>                                       | <b>172,950</b>     | <b>191,219</b>      | <b>234,795</b>      | <b>294,110</b>       | <b>541,911</b>         |                  |
| <b>Interest Rate Sensitive Liabilities</b>                                    |                    |                     |                     |                      |                        |                  |
| Interest checking (2)   | -                  | -                   | -                   | 36,973               | -                      | 36,973           |
| Money market accounts   | 91,236             | -                   | -                   | -                    | -                      | 91,236           |
| Savings (2)   | -                  | -                   | -                   | 11,829               | -                      | 11,829           |
| Certificates of deposit   | 61,957             | 41,078              | 61,365              | 101,389              | 53,097                 | 318,886          |
| FHLB advances   | 5,000              | 1,000               | 1,000               | 18,750               | 13,000                 | 38,750           |
| Trust Preferred Securities  | -                  | -                   | -                   | -                    | 8,764                  | 8,764            |
| Federal funds purchased   | -                  | -                   | -                   | -                    | -                      | -                |
| Other borrowings  | 5,241              | -                   | -                   | -                    | -                      | 5,241            |
| <b>Total rate sensitive liabilities</b>                                       | <b>163,434</b>     | <b>42,078</b>       | <b>62,365</b>       | <b>168,941</b>       | <b>74,861</b>          | <b>511,679</b>   |
| <b>Cumulative rate sensitive liabilities</b>                                  | <b>163,434</b>     | <b>205,512</b>      | <b>267,877</b>      | <b>436,818</b>       | <b>511,679</b>         |                  |
| <b>Rate sensitivity gap for period</b>  | <b>\$ 9,516</b>    | <b>\$ (23,809 )</b> | <b>\$ (18,789 )</b> | <b>\$ (109,626 )</b> | <b>\$ 172,940</b>      | <b>\$ 30,232</b> |
| <b>Cumulative rate sensitivity gap</b>  | <b>\$ 9,516</b>    | <b>\$ (14,293 )</b> | <b>\$ (33,082 )</b> | <b>\$ (142,708 )</b> | <b>\$ 30,232</b>       |                  |
| <b>Ratio of cumulative gap to total assets</b>                                | <b>1.6</b>         | <b>% (2.4 )%</b>    | <b>(5.4 )%</b>      | <b>(23.5 )%</b>      | <b>5.0</b>             | <b>%</b>         |
| <b>Ratio of cumulative rate sensitive assets to cumulative rate sensitive</b> |                    |                     |                     |                      |                        |                  |

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|   |       |   |      |    |       |    |       |    |       |   |
|---|-------|---|------|----|-------|----|-------|----|-------|---|
| liabilities   | 105.8 | % | 93.0 | %  | 87.7  | %  | 67.3  | %  | 105.9 | % |
| Ratio of cumulative gap to cumulative rate sensitive assets | 5.5   | % | (7.5 | )% | (14.1 | )% | (48.5 | )% | 5.6   | % |

(1) Includes nonaccrual loans of approximately \$17,568,000, which are spread throughout the categories.

(2) Management believes that interest checking and savings accounts are generally not sensitive to changes in interest rates and therefore has placed such deposits in the "13 to 36 months" category.

At March 31, 2011, our balance sheet is asset sensitive for the first three months, meaning that our assets reprice more quickly than our liabilities during that period, and liability sensitive for the next thirty-three months, meaning that our liabilities will reprice more quickly than our assets during that period, with a ratio of cumulative gap to total assets ranging from a positive gap of 1.6% for the first three months to a negative gap of (23.5)% for thirteen to thirty six month period. A negative gap can adversely affect earnings in periods of increasing interest rates. Given expectations of rising interest rates by the end of 2011, we believe our balance sheet should be asset sensitive and, accordingly, we have adopted pricing policies to lengthen the maturities/repricing of our liabilities relative to the maturities/pricing of our assets.

### Critical accounting policies

The accounting and reporting policies of the Company and its subsidiary are in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and conform to general practices within the banking industry. The Company’s financial position and results of operations are affected by management’s application of accounting policies, including estimates, assumptions and judgments made to arrive at the carrying value of assets and liabilities, and amounts reported for revenues, expenses and related disclosures. Different assumptions in the application of these policies could result in material changes in the Company’s consolidated financial position and/or results of operations.

The more critical accounting and reporting policies include the Company’s accounting for the allowance for loan losses, real estate acquired in settlement of loans, goodwill and income taxes. The Company’s accounting policies are fundamental to understanding the Company’s consolidated financial position and consolidated results of operations. Accordingly, the Company’s significant accounting policies are discussed in detail in Note 1 of the Notes to Consolidated Financial Statements.

The following is a summary of the Company’s critical accounting policies that are highly dependent on estimates, assumptions, and judgments.

#### Allowance for loan losses

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan portfolio. We maintain policies and procedures that address the systems of controls over the following areas of maintenance of the allowance: the systematic methodology used to determine the appropriate level of the allowance to provide assurance they are maintained in accordance with accounting principles generally accepted in the United States of America; the accounting policies for loan charge-offs and recoveries; the assessment and measurement of impairment in the loan portfolio; and the loan grading system.

The allowance reflects management’s best estimate of probable losses within the existing loan portfolio and of the risk inherent in various components of the loan portfolio, including loans identified as impaired as required by FASB Codification Topic 310: Receivables. Loans evaluated individually for impairment include non-performing loans, such as loans on non-accrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment.

Loans are grouped by similar characteristics, including the type of loan, the assigned loan classification and the general collateral type. A loss rate reflecting the expected loss inherent in a group of loans is derived based upon estimates of default rates for a given loan grade, the predominant collateral type for the group and the terms of the loan. The resulting estimate of losses for groups of loans is adjusted for relevant environmental factors and other conditions of the portfolio of loans and leases, including: borrower and industry concentrations; levels and trends in delinquencies, charge-offs and recoveries; changes in underwriting standards and risk selection; level of experience, ability and depth of lending management; and national and local economic conditions.

The amounts of estimated impairment for individually evaluated loans and groups of loans are added together for a total estimate of loan losses. This estimate of losses is compared to our allowance for loan losses as of the evaluation date and, if the estimate of losses is greater than the allowance, an additional provision to the allowance would be made. If the estimate of losses is less than the allowance, the degree to which the allowance exceeds the estimate is evaluated to determine whether the allowance falls outside a range of estimates. If the estimate of losses is below the range of reasonable estimates, the allowance would be reduced by way of a credit to the provision for loan losses. We recognize the inherent imprecision in estimates of losses due to various uncertainties and variability related to the factors used, and therefore a reasonable range around the estimate of losses is derived and used to ascertain whether the allowance is too high. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the financial statements.

#### Real estate acquired in settlement of loans

Real estate acquired in settlement of loans represent properties acquired through foreclosure or physical possession. Write-downs to fair value of foreclosed assets at the time of transfer are charged to allowance for loan losses. Subsequent to foreclosure, the Company periodically evaluates the value of foreclosed assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. Subsequent declines in value are charged to operations. Fair value is based on an assessment of information available at the end of a reporting period and depends upon a number of factors, including historical experience, economic conditions, and issues specific to individual properties. The evaluation of these factors involves subjective estimates and judgments that may change.

#### Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established. Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if management projects lower levels of future taxable income. If such a valuation allowance is deemed necessary in the future, it would be established through a charge to income tax expense that would adversely affect operating results.

#### New accounting standards

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures, amending Topic 820. The ASU provides for additional disclosures of transfers between assets and liabilities valued under Level 1 and 2 inputs as well as additional disclosures regarding those assets and liabilities valued under Level 3 inputs. The new disclosures are effective for interim and annual reporting periods beginning after December 15, 2009 except for those provisions addressing Level 3 fair value measurements which provisions are effective for fiscal years, and periods therein, beginning after December 15, 2010. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.



In July 2010, The FASB issued ASU No. 2010-20, Receivables - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, Topic 830. This ASU requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 will be effective for the Company's consolidated financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period are required for the Company's consolidated financial statements that include periods beginning on or after January 1, 2011. This ASU required additional disclosures only and did not have an impact on the Company's consolidated financial statements.

In January 2011, the FASB issued ASC Update 2011-01, Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20. This update temporarily delays the effective date of the disclosures about troubled debt restructuring postponed the effective date of the disclosures about troubled debt restructuring in ASU 2010-20 for public companies. The delay is intended to allow FASB to complete its deliberations on what constitutes a troubled debt restructuring. The guidance on both disclosures about troubled debt restructuring and determining what constitutes a troubled debt restructuring will be coordinated and is anticipated to be issued for interim and annual periods after June 15, 2011.

In April 2011, The FASB issued ASU No. 2011-02, Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 will be effective for the Company on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. Adoption of ASU 2011-02 is not expected to have a significant impact on the Company's consolidated financial statements.

#### Impact of inflation and changing prices

The Company's consolidated financial statements included herein have been prepared in accordance with generally accepted accounting principles in the United States, which require the Company to measure financial position and operating results primarily in terms of historical dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Company is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Company, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.





ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable.

ITEM 4 – CONTROLS AND PROCEDURES

Based upon an evaluation as of March 31, 2011 under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer of the effectiveness of the design and operation of the Company's disclosure controls and procedures, they have concluded that our disclosure controls and procedures, as defined in Rule 13a-15 and Rule 15d-15 under the Securities Exchange Act of 1934, as amended, are effective in ensuring that all material information required to be disclosed in reports that it files or submits under such Act is recorded, processed, summarized and is made known to management in a timely fashion.

Our management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in our internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company's last fiscal quarter that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1 – LEGAL PROCEEDINGS

Not applicable.

ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4 – REMOVED AND RESERVED

ITEM 5 – OTHER INFORMATION

Not applicable.

ITEM 6 – EXHIBITS

31.1 Certification of Chief Executive Officer

31.2 Certification of Chief Financial Officer

32.1 Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

SIGNATURES

In accordance with 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.

VILLAGE BANK AND TRUST FINANCIAL CORP.  
(Registrant)

Date: May 13, 2011

By: /s/ Thomas W. Winfree  
Thomas W. Winfree  
President and  
Chief Executive Officer

Date: May 13, 2011

By: /s/ C. Harril Whitehurst, Jr.  
Senior Vice President and  
Chief Financial Officer

EXHIBIT INDEX

| Exhibit<br>Number | Document   |
|-------------------|--|
| 31.1              | Certification of Chief Executive Officer   |
| 31.2              | Certification of Chief Financial Officer   |
| 32.1              | Statement of Chief Executive Officer and Chief Financial Officer<br>Pursuant to 18 U.S.C. Section 1350 |

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