

Village Bank & Trust Financial Corp.  
Form 10-K  
March 22, 2007

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-KSB**

**ANNUAL REPORT UNDER SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2006**

**TRANSITION REPORT UNDER SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

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

**Commission file number 0-50765**

**VILLAGE BANK AND TRUST FINANCIAL CORP.**

(Name of small business issuer in its charter)

**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**16-1694602**  
(I.R.S. Employer  
Identification No.)

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**1231 Alverser Drive, P.O. Box 330, Midlothian, Virginia**  
(Address of principal executive offices)

**23113**  
(Zip Code)

Issuer's telephone number **804-897-3900**

**Securities registered under Section 12(b) of the Exchange Act:**

None

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Common Stock, \$4.00 par value	The Nasdaq Stock Market

**Securities registered under Section 12(g) of the Exchange Act:**

None

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

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

Yes  No

State issuer's revenues for its most recent fiscal year. \$21,502,000.

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The aggregate market value of common stock held by non-affiliates of the registrant as of March 19, 2007 was approximately \$39,969,000.

The number of shares of common stock outstanding as of March 19, 2007 was 2,562,088.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be used in conjunction with the 2007 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-KSB.

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**Village Bank and Trust Financial Corp.**

**Form 10-KSB**

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**PART I**

**ITEM 1 DESCRIPTION OF BUSINESS**

**General**

Village Bank and Trust Financial Corp. (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, Village Bank (the Bank). The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Company acquired or formed three wholly owned subsidiaries of the Bank, Village Bank Mortgage Corporation (Village Bank Mortgage), a full service mortgage banking company, Village Insurance Agency, Inc. (Village Insurance), a full service property and casualty insurance agency, and Village Financial Services Corporation (Village Financial Services), a financial services company.

The Company is the holding company of and successor to the Bank. Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction. In the transaction, the shares of the Bank's common stock were exchanged for shares of the Company's common stock, par value \$4.00 per share (Common Stock), on a one-for-one basis. As a result, the Bank became a wholly owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company. All references to the Company in this annual report for dates or periods prior to April 30, 2004 are references to the Bank.

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 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 our customers. We conduct our operations from our main office/corporate headquarters location in which we have an operating branch, and we have eight additional branch offices.

The Company was incorporated in January 2003.

**Business Strategy**

Our strategies include the following:

*To be a full service financial services provider enabling us to establish and maintain relationships with our customers.*

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*To attract customers by providing the breadth of products offered by larger banks while maintaining the quick response and personal service of a community bank. We will continue to look for opportunities to expand our products and services. In our first seven years of operation, we have established a diverse product line, including commercial, mortgage and consumer loans as well as a full array of deposit products and services.*

*To increase net income and return to shareholders through continued loan growth, while controlling the cost of our deposits and noninterest expenses.*

*To expand our branch network to lower our cost of funds and diversify our loan portfolio with retail, consumer and commercial loans.* We believe that branching will help us attract customers of financial institutions that have consolidated in our region who desire the personal services of a community bank. We plan to open two new branches in 2007, further expanding our presence in Chesterfield and Henrico Counties. Our ability to open new branches, however, may be affected by such things as availability of building materials, weather conditions, site approval by local government and regulatory approval.

*To expand our capacity to generate noninterest income through the sale of mortgage loans.* In 2005, we opened a new loan production office in Henrico County which we believe will expand our ability to originate mortgage loans for sale.

*To continue to emphasize commercial banking products and services.* Small-business commercial customers are a source of prime-based loans, fee income from cash management services, and low cost deposits, which we need to fund our growth. We have been able to build a commercial business base because our staff of commercial bankers seeks opportunities to network within the local business community. Significant additional growth in this banking area will depend on expanding our lending staff.

*To target larger commercial customers.* In 2006, we increased our capital by approximately \$7.2 million through the exercise of common stock warrants issued in 2002. This increase in capital increased our legal lending limit to approximately \$4,000,000. Increasing our legal lending limit will help us accommodate the borrowing needs of larger customers.

Our officers, employees and the directors live and work in our market area. We believe that the existing and future banking market in our community represents an opportunity for locally owned and locally managed community banks. In view of the continuing trend in the financial services industry toward consolidation into larger, sometimes impersonal, statewide, regional and national institutions, the market exists for the personal and customized financial services that an independent, locally owned bank with local decision making can offer. With the flexibility of our smaller size and through an emphasis on relationship banking, including personal attention and service, we can be more responsive to the individual needs of our customers than our larger competitors. As a community oriented and locally managed institution, we make most of our loans in our community and can tailor our services to meet the banking and financial needs of our customers who live and do business in our market.

We provide customers with high quality, responsive and technologically advanced banking services. These services include loans that are priced on a deposit-based relationship, easy access to our decision makers, and quick and innovative action necessary to meet a customer's banking needs.

## **Location and Market Area**

We have focused our operations in Chesterfield County, Virginia, which, despite its potential for business development and population growth, has been underserved by community banks. Chesterfield's resources are very favorable for businesses seeking a profitable and stable environment. The county offers superb commercial and industrial sites, an educated work force, well-designed and developed infrastructure and a competitive tax structure. Chesterfield has been awarded the U.S. Senate Gold Medallion for Productivity and Quality. The county has the highest bond rating from three rating agencies - Standard and Poors, Moody's and Fitch.

Our strategy is to build a strong community banking franchise and branch network in Chesterfield and then expand our franchise into other counties in the Richmond Metropolitan area. In Henrico County, we opened a loan production office in 2005 and a retail branch in 2006. We have also expanded our community network in 2006 by opening a retail branch in Powhatan County. In 2007,





we have plans to open two more branches, one in Chesterfield County and one in Henrico County. Chesterfield, Henrico and Powhatan Counties have each seen strong population growth in recent years, and the growth trends are expected to continue. According to the U.S. Census Bureau, the 2000 population of Chesterfield County was 259,903, compared to 209,274 in 1990. The number of households in Chesterfield County climbed from 73,441 in 1990 to 93,772 in 2000. The projected figures for 2010 are a population of 319,000 in 117,500 households. The 2000 population of Henrico County was 262,300 compared to 217,849 in 1990. The number of households in 2000 was 108,121 compared to 89,138 in 1990. The projected figures for Henrico County for 2010 are a population of 291,000 in 122,900 households. These population figures place Henrico and Chesterfield, respectively, as the largest two counties in central Virginia and the third and fourth largest counties in the state.

Residential growth in Chesterfield, Henrico and Powhatan Counties remains strong. For the four quarters ended September 30, 2006, Chesterfield County issued 5,564 permits for new single-family homes, Henrico County issued 4,313 and Powhatan County issued 874. Unemployment percentages for Chesterfield, Henrico and Powhatan for the third quarter of 2006 were 2.8%, 3.0% and 2.8%, respectively, well below the national average of 4.7%. Developers continue to locate their planned communities in western Chesterfield County. The Winterpock area of Chesterfield County is expected to see substantial growth over the next six years, with the Deer Run development nearing completion and subdivisions such as Birkdale, Ashbrook, and Bayhill Point continuing their impressive growth. The primary road serving these growing subdivisions is Route 360, and all of these communities are within two miles of our Clover Hill branch. Henrico County has long been a strong bedroom community to Richmond. Many of the metropolitan Richmond area's older upscale housing communities call Henrico home and the western part of Henrico has seen substantial growth in both new business as well as residential communities. The western section of Route 288, the circumferential highway around the Richmond Metropolitan area, was completed in 2004 and significantly improved access to and from Chesterfield County and Henrico County by the surrounding counties.

At December 31, 2006, we had nine full service banking offices (including one in our main office), which were staffed by 38 full-time employees. Our senior staff averages more than 25 years of professional or banking experience. Our principal office, which houses our executive officers and loan department, was opened in November 2003 and is located at 1231 Alverser Drive, Midlothian, Virginia 23113. One of our branch facilities is located in this building. Our main telephone number is (804) 897-3900. Six of our branch offices are located in Chesterfield County, with one branch office each in Henrico and Powhatan Counties. Each branch office has been strategically located to be convenient to business and retail customers in the growth sectors of Chesterfield County. In addition to our branch locations, we opened a loan production office in Henrico County in 2005.

We have plans to open two more branches in 2007 with emphasis in the Henrico market and expanding into Mechanicsville, Virginia. The opening of any additional banking offices will require prior regulatory approval, which takes into account a number of factors, including, among others, a determination that we have capital in an amount deemed sufficient to warrant additional expansion and a finding that the public interest will be served.

Prominent local newspapers, one regional newspaper, and a number of radio and television stations provide diverse media outlets. The broad exposure of television, print media and radio offers several opportunities to explore effective advertising and public relations avenues for the Company.

### **Banking Services**

We receive deposits, make consumer and commercial loans, and provide other services customarily offered by a commercial banking institution, such as business and personal checking and savings accounts, drive-up windows, and 24-hour automated teller machines. We have not applied for permission to establish a trust department and offer trust services. We are not a member of the Federal Reserve System. Our deposits are insured under the Federal Deposit Insurance Act to the



limits provided thereunder.

We offer a full range of short-to-medium term commercial and personal loans. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements) and purchase of equipment and machinery. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education and personal investments. We also originate fixed and variable rate mortgage loans and real estate construction and acquisition loans. Fixed rate residential loans are usually sold in the secondary mortgage market.

Our lending activities are subject to a variety of lending limits imposed by federal and state law. While differing limits apply in certain circumstances based on the type of loan or the nature of the borrower (including the borrower's relationship to the bank), in general, for loans that are not secured by readily marketable or other permissible collateral, we are subject to a loans-to-one borrower limit of an amount equal to 15% of our capital and surplus. We may voluntarily choose to impose a policy limit on loans to a single borrower that is less than the legal lending limit. We are a member of the Community Bankers' Bank and may participate out portions of loans when loan amounts exceed our legal lending limits or internal lending policies.

### **Lending Activities**

Our primary focus is on making loans to small businesses and consumers in our local market area. In addition, we also provide a wide range of real estate finance services. Our primary lending activities are principally directed to our market area.

*Loan Portfolio.* The net loan portfolio was \$238,498,000 at December 31, 2006, which compares to \$170,447,000 at December 31, 2005. The Company has enjoyed strong loan growth the last two years reflecting the strong economy in the market we serve. Loans grew by 27% in 2005 and by 40% in 2006. Our loan customers are generally located in the Richmond metropolitan area. We do not have any subprime loans in our loan portfolio.

*Commercial Business Lending.* Our commercial business lending consists of lines of credit, revolving credit facilities, term loans, equipment loans, stand-by letters of credit and unsecured loans. Commercial loans are written for any business purpose including the financing of plant and equipment, carrying accounts receivable, general working capital, contract administration and acquisition activities. Our client base is diverse, and we do not have a concentration of loans in any specific industry segment. Commercial business loans are generally secured by accounts receivable, equipment, inventory and other collateral such as marketable securities, cash value of life insurance, and time deposits. Commercial business loans have a higher degree of risk than residential mortgage loans, but have higher yields. To manage these risks, we generally obtain appropriate collateral and personal guarantees from the borrower's principal owners and monitor the financial condition of business borrowers. The availability of funds for the repayment of commercial business loans may substantially depend on the success of the business itself. Further, the collateral for commercial business loans may depreciate over time and cannot be appraised with as much precision as residential real estate. All commercial loans we make have recourse under the terms of a promissory note. At December 31, 2006, commercial loans totaled \$17,889,000, or 7.4% of the total loan portfolio.

*Commercial Real Estate Lending.* We finance commercial real estate for our clients and commercial real estate loans represent the largest segment of our loan portfolio. This segment of our loan portfolio has been the largest segment since 2004 due to the significant real estate opportunities in our market area. We generally will finance owner-occupied commercial real estate at an 80% loan-to-value ratio or less. In many cases our loan-to-value ratio is less than 80%, which provides us with a higher level of collateral security. Our underwriting policies and

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procedures focus on the borrower's ability to repay the loan as well as assessment of the underlying real estate. Risks inherent in managing a commercial real estate loan portfolio relate to sudden or gradual drops in property values as well as changes in the economic climate. We attempt to mitigate those risks by

carefully underwriting loans of this type as well as following appropriate loan-to-value standards. Commercial real estate loans (generally owner occupied) at December 31, 2006 were \$100,039,000, or 41.4% of the total loan portfolio.

*Real Estate Construction Lending.* This segment of our loan portfolio is predominately residential in nature and comprised of loans with short duration, meaning maturities of twelve months or less. Residential houses under construction and the underlying land for which the loan was obtained secure the construction loans. Construction lending entails significant risks compared with residential mortgage lending. These risks involve larger loan balances concentrated with single borrowers with funds advanced upon the security of the land and home under construction, which is estimated prior to the completion of the home. Thus it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate these risks we generally limit loan amounts to 80% of appraised values on pre-sold homes and 75% on speculative homes, and obtain first lien positions on the property taken as security. Additionally, we offer real estate construction financing to individuals who have demonstrated the ability to obtain a permanent loan. At December 31, 2006, construction loans total \$80,324,000, or 33.3% of the total loan portfolio.

*Residential Mortgage Lending.* We make permanent residential mortgage loans for inclusion in the loan portfolio. We seek to retain in our portfolio variable rate loans secured by one-to-four-family residences. However, the majority of permanent residential loans are made by the Bank's subsidiary, Village Bank Mortgage, which sells them to investors in the secondary mortgage market on a pre-sold basis. Given the low fixed rate residential loan market in recent years, this allows us to offer this service to our customers without retaining a significant low rate residential loan portfolio which would be detrimental to earnings as interest rates increase. We originate both conforming and non-conforming single-family loans.

Before we make a loan we evaluate both the borrower's ability to make principal and interest payments and the value of the property that will secure the loan. We make first mortgage loans in amounts up to 95% of the appraised value of the underlying real estate. We retain some second mortgage loans secured by property in our market area, as long as the loan-to-value ratio combined with the first mortgage does not exceed 90%. For conventional loans in excess of 80% loan-to-value, private mortgage insurance is required.

Our current one-to-four-family residential adjustable rate mortgage loans have interest rates that adjust every 1, 3 and 5 years, generally in accordance with the rates on comparable U.S. Treasury bills. Our adjustable rate mortgage loans generally limit interest rate increases to 2% each rate adjustment period and have an established ceiling rate at the time the loans are made of up to 6% over the original interest rate. There are risks resulting from increased costs to a borrower as a result of the periodic repricing mechanisms of these loans. Despite the benefits of adjustable rate mortgage loans to our asset/liability management, they pose additional risks, primarily because as interest rates rise, the underlying payments by the borrowers rise, increasing the potential for default. At the same time, the marketability of the underlying property may be adversely affected by higher interest rates. At December 31, 2006, \$36,408,000, or 15.1% of our loan portfolio, consisted of residential mortgage loans.

*Consumer Installment Lending.* We offer various types of secured and unsecured consumer loans. We make consumer loans primarily for personal, family or household purposes as a convenience to our customer base since these loans are not the primary focus of our lending activities. Our general guideline is that a consumer's total debt service should not exceed 40% of the consumer's gross income. Our underwriting standards for consumer loans include making a determination of the applicant's payment history on other debts and an assessment of his or her ability to meet existing obligations and payments on the proposed loan. The stability of an applicant's monthly income may be determined by verification of gross monthly income from primary employment and additionally from any verifiable secondary income. Consumer loans totaled \$6,730,000 at December 31, 2006, which was 2.8% of the total loan portfolio.



*Loan Commitments and Contingent Liabilities.* In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities which are disclosed in the footnotes of our annual financial statements, including commitments to extend credit. At December 31, 2006, undisbursed credit lines, standby letters of credit and commitments to extend credit totaled \$97,579,000.

*Credit Policies and Administration.* We have adopted a comprehensive lending policy, which includes stringent underwriting standards for all types of loans. Our lending staff follows pricing guidelines established periodically by our management team. In an effort to manage risk, all credit decisions in excess of the officers' lending authority must be approved prior to funding by a management loan committee and/or a board of directors-level loan committee. Any loans above \$2,000,000 require full board of directors' approval. Management believes that it employs experienced lending officers, secures appropriate collateral and carefully monitors the financial conditions of our borrowers and the concentration of such loans in the portfolio.

In addition to the normal repayment risks, all loans in our portfolio are subject to the state of the economy and the related effects on the borrower and/or the real estate market. Generally, longer-term loans have periodic interest rate adjustments and/or call provisions. Our senior management monitors the loan portfolio closely to ensure that past due loans are minimized and that potential problem loans are swiftly dealt with. In addition to the internal business processes employed in the credit administration area, the Company utilizes its internal audit firm to review the loan portfolio. A detailed annual review is performed, with an interim update occurring at least once a year. Results of the report are used to validate our internal loan ratings and to provide independent commentary on specific loans and loan administration activities.

*Lending Limit.* As of December 31, 2006, our legal lending limit for loans to one borrower was approximately \$4,000,000. As part of our risk management strategy, we attempt to participate a portion of our larger loans to other financial institutions. This allows us to maintain customer relationships yet reduce credit exposure and stay within our legal lending limit.

## **Investments and Funding**

We balance our liquidity needs based on loan and deposit growth via the investment portfolio, purchased federal funds, and Federal Home Loan Bank advances. It is our goal to provide adequate liquidity to support our loan growth. Should we have excess liquidity, investments are used to generate positive earnings. In the event deposit growth does not fully support our loan growth, a combination of investment sales, federal funds and Federal Home Loan Bank advances will be used to augment our funding position.

Our investment portfolio is actively monitored and is classified as available for sale. Under such a classification, investment instruments may be sold as deemed appropriate by management. On a monthly basis, the investment portfolio is marked to market via equity as required by SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Additionally, we use the investment portfolio to balance our asset and liability position. We will invest in fixed rate or floating rate instruments as necessary to reduce our interest rate risk exposure.

For securities classified as available-for-sale securities, we will evaluate whether a decline in fair value below the amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings. There were no securities at December 31, 2006 where a decline in market value was considered other than temporary.

**Competition**

We encounter strong competition from other local commercial banks, savings and loan associations,



credit unions, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market mutual funds and other financial institutions. A number of these competitors are well-established. Competition for loans is keen, and pricing is important. Most of our competitors have substantially greater resources and higher lending limits than ours and offer certain services, such as extensive and established branch networks and trust services, which we do not provide at the present time. Deposit competition also is strong, and we may have to pay higher interest rates to attract deposits. Nationwide banking institutions and their branches have increased competition in our markets, and federal legislation adopted in 1999 allows non-banking companies, such as insurance and investment firms, to establish or acquire banks.

The greater Richmond metropolitan market has experienced several significant mergers or acquisitions involving all four regional banks formerly headquartered in central Virginia over the past fifteen years. Additionally, other larger banks from outside Virginia have acquired local banks. We believe that the Company can capitalize on the recent merger activity and attract customers from those who are dissatisfied with the recently acquired banks.

At June 30, 2006, the latest date such information is available from the FDIC, the Bank's deposit market share in Chesterfield County was 6.39%.

#### **Effect of Adverse Economic Conditions**

Our business may be adversely affected by periods of economic slowdown or recession which may be accompanied by decreased demand for consumer credit and declining real estate values. Any material decline in real estate values could have a significant adverse effect on the operations of the Company as 89.8% of our loan portfolio is collateralized by real estate. Declines in real estate values can reduce projected cash flows from commercial properties and the ability of borrowers to use home equity to support borrowings and increase the loan-to-value ratios of loans previously made by us, thereby weakening collateral coverage and increasing the possibility of a loss in the event of default. In addition, delinquencies, foreclosures and losses generally increase during economic slowdowns or recessions.

We anticipate the majority of our depositors will be located in and doing business in the local market and we will lend a substantial portion of our capital and deposits to individuals and businesses in this market area. Any factors adversely affecting the economy of this market could, in turn, adversely affect our performance.

#### **Regulation**

We are subject to regulations of certain federal and state agencies and receive periodic examinations by those regulatory authorities. As a consequence of the extensive regulation of commercial banking activities, our business is susceptible to being affected by state and federal legislation and regulations.

**General.** The discussion below is only a summary of the principal laws and regulations that comprise the regulatory framework applicable to us. The descriptions of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, do not purport to be complete and are qualified in their entirety by reference to applicable laws and regulations. In recent years, regulatory compliance by financial institutions such as ours has placed a significant burden on us both in costs and employee time commitment.

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**Bank Holding Company.** The Company is a bank holding company under the Federal Bank Holding Company Act of 1956, as amended, and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board ) and Virginia State Corporation Commission ( SCC ). As a bank holding company, the Company is required to furnish to the Federal Reserve Board an annual report of its operations at the end of each fiscal year and to furnish such additional information as the Federal Reserve Board may require pursuant to the

Bank Holding Company Act. The Federal Reserve Board, FDIC and SCC also may conduct examinations of the Company and/or its subsidiary bank.

The Gramm-Leach-Bliley Act of 1999 (the Act) draws new lines between the types of activities that are financial in nature and permitted for banking organizations, and those activities that are commercial in nature and not permitted. The Act imposes Community Reinvestment requirements on financial service organizations that seek to qualify for the expanded powers to engage in broader financial activities and affiliations with financial companies that are permitted.

The Act allows a financial holding company to own banks, insurance companies and securities firms. A financial holding company is authorized to engage in any activity that is financial in nature, incidental to an activity that is financial in nature, or is a complimentary activity. These activities may include insurance, securities transactions, and traditional banking activities. The Act establishes a consultative and cooperative procedure between the Federal Reserve and the Secretary of the Treasury for purposes of determination as to the scope of activities permitted by the Act.

A bank holding company must satisfy special criteria to qualify for the expanded powers authorized by the Act, including the maintenance of a well-capitalized and well-managed status for all affiliate banks and a satisfactory community reinvestment rating.

**Bank Regulation.** As a Virginia state-chartered bank that is not a member of the Federal Reserve System, the Bank is subject to regulation, supervision and examination by the SCC's Bureau of Financial Institutions (BFI). The Bank is also subject to regulation, supervision and examination by the FDIC. Federal law also governs the activities in which we may engage, the investments we may make and the aggregate amount of loans that may be granted to one borrower. Various consumer and compliance laws and regulations also affect our operations. Earnings are affected by general economic conditions, management policies and the legislative and governmental actions of various regulatory authorities, including those referred to above. The following description summarizes some of the laws to which we are subject. The BFI and the FDIC will conduct regular examinations, reviewing such matters as the adequacy of loan loss reserves, quality of loans and investments, management practices, compliance with laws, and other aspects of their operations. In addition to these regular examinations, we must furnish the FDIC with periodic reports containing a full and accurate statement of our affairs. Supervision, regulation and examination of banks by these agencies are intended primarily for the protection of depositors rather than shareholders.

**Insurance of Accounts, Assessments and Regulation by the FDIC.** Our deposits are insured by the FDIC up to the limits set forth under applicable law, currently \$100,000. Deposits are subject to the deposit insurance assessments of the Bank Insurance Fund (BIF) of the FDIC. The FDIC is authorized to prohibit any BIF-insured institution from engaging in any activity that the FDIC determines by regulation or order to pose a serious threat to the respective insurance fund. Also, the FDIC may initiate enforcement actions against banks, after first giving the institution's primary regulatory authority an opportunity to take such action. The FDIC may terminate the deposit insurance of any depository institution if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed in writing by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution has no tangible capital. If deposit insurance is terminated, the deposits at the institution at the time of termination, less subsequent withdrawals, shall continue to be insured for a period from six months to two years, as determined by the FDIC. We are aware of no existing circumstances that could result in termination of our deposit insurance.

**Capital.** The FDIC has issued risk-based and leverage capital guidelines applicable to banking organizations they supervise. Under the risk-based capital requirements, we are generally required to maintain a minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit), of 8%. At least half of the total capital is to be composed of common equity, retained earnings and qualifying perpetual preferred stock, less certain



intangibles ( Tier 1 capital ). The remainder may consist of certain subordinated debt, certain hybrid capital instruments and other qualifying preferred stock and a limited amount of the loan loss allowance ( Tier 2 capital and, together with Tier 1 capital, total capital ). In addition, each of the Federal bank regulatory agencies has established minimum leverage capital ratio requirements for banking organizations. These requirements provide for a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets equal to 4% for banks and bank holding companies that meet certain specified criteria. All other banks and bank holding companies will generally be required to maintain a leverage ratio of at least 100 to 200 basis points above the stated minimum. The risk-based capital standards of the FDIC explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution's overall capital adequacy. The capital guidelines also provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a bank's capital adequacy.

**Other Safety and Soundness Regulations.** There are a number of obligations and restrictions imposed on depository institutions by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insurance funds in the event the depository institution becomes in danger of default or is in default. The Federal banking agencies also have broad powers under current Federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution in question is well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized, as defined by the law. Federal regulatory authorities also have broad enforcement powers over us, including the power to impose fines and other civil and criminal penalties, and to appoint a receiver in order to conserve the assets of any such institution for the benefit of depositors and other creditors. Village Bank continues to be classified as a well-capitalized financial institution.

**Loans-to-One Borrower.** Under applicable laws and regulations the amount of loans and extensions of credit which may be extended by a bank to any one borrower, including related entities, generally may not exceed 15% of the unimpaired capital and unimpaired surplus of the institution. Loans in an amount equal to an additional 10% of unimpaired capital and unimpaired surplus also may be made to a borrower if the loans are fully secured by readily marketable securities. An institution's unimpaired capital and unimpaired surplus includes, among other things, the amount of its core capital and supplementary capital included in its total capital under Federal regulations.

**Community Reinvestment.** The requirements of the Community Reinvestment Act ( CRA ) are applicable to the Company. The CRA imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those institutions. A financial institution's efforts in meeting community credit needs currently are evaluated as part of the examination process pursuant to 12 assessment factors. These factors also are considered in evaluating mergers, acquisitions and applications to open a branch or facility.

**Economic and Monetary Policies.** Our operations are affected not only by general economic conditions, but also by the economic and monetary policies of various regulatory authorities. In particular, the Federal Reserve regulates money, credit and interest rates in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits and affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

## **Employees**

As of December 31, 2006, the Company and its subsidiaries had a total of 109 full-time employees and 11 part-time employees. None of the Company's employees are covered by a collective bargaining agreement. The Company considers its relations with its employees to be good.

## **Dependence on Key Personnel**

Our growth and development to date have been largely dependent upon the services of Thomas W. Winfree, President and Chief Executive Officer, Jack M. Robeson, Senior Vice President/Lending, Raymond E. Sanders, Senior Vice President and Chief Operations Officer, Dennis J. Falk, Senior Vice President/Lending and Administration and C. Harril Whitehurst, Jr., Senior Vice President and Chief Financial Officer. The loss of the services for Messrs. Winfree, Robeson, Sanders or Whitehurst for any reason could have a material adverse effect on the Company.

## **Control by Certain Shareholders**

The Company has one shareholder who owns 6.50% of its outstanding Common Stock. As a group, the Board of Directors and the Company's Executive Officers control 20.63% of the outstanding Common Stock of the Company as of February 1, 2007. Accordingly, such persons, if they were to act in concert, would not have majority control of the Bank and would not have the ability to approve certain fundamental corporate transactions or the election of the Board of Directors.

**ITEM 2 DESCRIPTION OF PROPERTY**

Our executive and administrative offices are located at 1231 Alverser Drive, Midlothian, Virginia. We opened this office in November 2003. This office also houses our loan department and one of our retail branches. The two-story 8,000 square foot building, which has been substantially renovated, is owned by the bank. The cost of this building, including renovations, amounted to \$1,046,000.

Our largest deposit branch office is located at 13531 Midlothian Turnpike, Midlothian, Virginia. This was our initial office location and also housed our executive and administrative offices until the opening of the operations center on Alverser Drive. The building, which has been substantially renovated, is a two-story brick structure with a basement, consisting of approximately 3,500 square feet. It has five teller stations, three drive-up lanes and a drive-up ATM and night depository. Prior to December 31, 2002, this building was leased. It was purchased from our landlord on December 31, 2002 for \$1,713,000.

We have a branch office at 6736 Southshore Drive at Route 360 (Hull Street Road), in Chesterfield County. The building is a one-story brick structure consisting of approximately 2,400 square feet. The branch location was purchased in June 2002 for \$1,384,000. It has four teller stations, two drive-up lanes and a drive-up ATM and night depository.

We opened a third branch location at 4221 West Hundred Road, Chester, Virginia in April 2003. The building is a one-story brick structure with a basement consisting of approximately 1,800 square feet. The branch is being leased for a term of five years commencing April 1, 2003 and ending March 31, 2008 for total lease payments of approximately \$186,000 over the life of the lease. We have renewal options for two five year periods subsequent to the initial term. It has four teller stations, one drive-up lane and a drive-up ATM and night depository.

We opened our fourth branch at 13521 Waterford Place, in Chesterfield County, in October 2004 utilizing a mobile manufactured building which we purchased in April 2004 for \$46,000. The permanent branch building, a one-story brick structure consisting of approximately 2,400 square feet, was completed in June 2005 and cost \$646,000. It has three teller stations, two drive-up lanes and a drive-up ATM and night depository.

Our fifth branch, located at 6551 Centralia Road, in Chesterfield County, was opened in November 2005. The building is a one-story brick structure consisting of approximately 2,900 square feet. The branch is being leased for a term of eight years commencing November 19, 2005 and ending November 30, 2013 for total lease payments of approximately \$672,000 over the life of the lease. It has five teller stations, two drive-up lanes and a drive-up ATM and night depository.

In March 2006 we opened our sixth office at 11450 Robious Road, in Chesterfield County. We initially opened this branch with our mobile manufactured building and subsequently constructed a 2,400 square foot building that cost \$1,035,000 and is owned by the Bank. This branch has three teller stations, two drive-up lanes, and a drive-up ATM and night depository.

Our seventh office, located at 1650 Willow Lawn Drive, in Henrico County, was opened in May 2006. This is our first retail branch location outside Chesterfield County. The building is a three story brick structure. We lease the first floor consisting of approximately 3,000 square feet. The term of the lease is nine years commencing March 1, 2006 and ending February 28, 2016 with total lease payments of \$842,000 over the life of the lease. It has four teller stations, three drive thru lanes, a drive-up ATM and night depository.

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Our eighth office located at 1793 South Creek One was opened in December 2006 in Powhatan County. This is our first branch located in Powhatan County. This 2,400 square foot structure cost \$672,000 and has three teller stations, two drive-up lanes, a drive-up ATM and night depository.



Our properties are maintained in good operating condition and are suitable and adequate for our operational needs.

**ITEM 3 LEGAL PROCEEDINGS**

In the course of its operations, the Company may become a party to legal proceedings. There are no material pending legal proceedings to which the Company is a party or of which the property of the Company is subject.

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

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

**PART II****ITEM 5 MARKET FOR COMMON EQUITY****AND RELATED STOCKHOLDER MATTERS****Market Price of and Cash Dividends on the Company's Common Equity**

Shares of the Company's Common Stock trade on the Nasdaq Capital Market (formerly known as the Nasdaq SmallCap Market) under the symbol VBFC. The high and low trade prices of shares of the Company's Common Stock for the periods indicated were as follows:

	High	Low
<b>2005</b>		
1st quarter	\$ 11.99	\$ 11.00
2nd quarter	14.04	11.09
3rd quarter	13.00	12.50
4th quarter	13.75	12.75
<b>2006</b>		
1st quarter	\$ 14.35	\$ 12.50
2nd quarter	14.25	12.50
3rd quarter	14.75	13.00
4th quarter	14.55	13.55

At March 19, 2007, there were approximately 985 holders of record of Common Stock.

The Company has not paid any dividends on its Common Stock. We intend to retain all of our earnings to finance the Company's operations and we do not anticipate paying cash dividends for the foreseeable future. Any decision made by the Board of Directors to declare dividends in the future will depend on the Company's future earnings, capital requirements, financial condition and other factors deemed relevant by the Board. Banking regulations limit the amount of cash dividends that may be paid without prior approval of the Bank's regulatory agencies. Such dividends are limited to the lesser of the Bank's retained earnings or the net income of the previous two years combined with the current year net income.

The Company did not repurchase any of its Common Stock during the fourth quarter of 2006.



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**ITEM 6 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**Forward-looking statements**

Certain information contained in this discussion may include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are generally identified by phrases such as we expect, we believe or words of similar import. Such forward-looking statements involve known and unknown risks including, but not limited to, the following factors:

- interest rate fluctuations;
- risk inherent in making loans such as repayment risks and fluctuating collateral values;
- economic conditions in the Richmond metropolitan area;
- the ability to continue to attract low cost core deposits to fund asset growth;
- changes in general economic and business conditions;
- changes in laws and regulations applicable to us;
- competition within and from outside the banking industry;
- the ability to successfully manage the Company's growth or implement its growth strategies if it is unable to identify attractive markets, locations or opportunities to expand in the future;
- maintaining capital levels adequate to support the Company's growth;
- reliance on the Company's management team, including its ability to attract and retain key personnel;
- new products and services in the banking industry;
- problems with our technology, and
- changing trends in customer profiles and behavior.

Although we believe that our expectations with respect to the forward-looking statements are based upon reliable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements.

**General**

The Company was organized under the laws of the Commonwealth of Virginia to engage in commercial and retail banking. The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Company acquired or formed three wholly owned subsidiaries of the Bank, Village Bank Mortgage Corporation ( Village Bank Mortgage ), a full service mortgage banking company, Village Insurance Agency, Inc. ( Village Insurance ), a full service property and casualty insurance agency, and Village Financial Services Corporation ( Village Financial Services ), a financial services company.

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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 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 our customers. We conduct our operations from our main office/corporate headquarters location and eight branch offices.

The Company experienced record earnings of \$1,399,000 in 2006 as compared to earnings of \$1,231,000 in 2005 and \$862,000 in 2004. The improvement in net income in 2006 compared to 2005 and 2004 is even more significant when compared on a pretax basis. Pretax income for 2006

amounted to \$2,102,000 compared to \$1,699,000 in 2005 and \$522,000 in 2004, representing increases of 24% and 225%, respectively. Net income for 2004 was increased by an income tax benefit of approximately \$339,000 related to the removal of the valuation allowance on the Company's net deferred tax assets.

The 2004 earnings were affected by two nonrecurring items. First, the Company wrote-off approximately \$118,000 related to goodwill associated with the purchase in 2003 of the insurance subsidiary of the Bank. Second, the Company recorded an income tax benefit of approximately \$339,000 related to the removal of the valuation allowance on its net deferred tax assets. The net effect of these two items increased 2004 results by \$221,000, or \$0.11 per fully diluted share.

The continued improvement in our earnings over the last three years is a direct result of our growth.

Total assets increased to \$291,218,000 at December 31, 2006 from \$214,975,000 at December 31, 2005 and \$160,305,000 at December 31, 2004. This represents a three year growth rate in total assets of 38%. This growth in total assets during the last three years resulted from the growth of our business and customer base and has been responsible for our improvement in earnings. However, this growth has been driven primarily by lending on real estate. Any material decline in real estate values could have a significant adverse effect on the future growth and profitability of the Company as 89.8% of our loan portfolio at December 31, 2006 is collateralized by real estate. Declines in real estate values can reduce projected cash flows from commercial properties and the ability of borrowers to use home equity to support borrowings and increase the loan-to-value ratios of loans previously made by us, thereby weakening collateral coverage and increasing the possibility of a loss in the event of default. In addition, delinquencies, foreclosures and losses generally increase during economic slowdowns or recessions.

The following presents management's discussion and analysis of the financial condition of the Company at December 31, 2006 and 2005, and results of operations for the Company for the years ended December 31, 2006, 2005 and 2004. This discussion should be read in conjunction with the Company's audited Financial Statements and the notes thereto appearing elsewhere in this report.

#### **Asset/liability management**

Management strives to manage the maturity or repricing match between assets and liabilities. The degree to which the Company is mismatched in its maturities is a primary measure of interest rate risk. In periods of stable interest rates, net interest income can be increased by financing higher yielding long-term mortgage loan assets with lower cost short-term deposits and borrowings. Although such a strategy may increase profits in the short run, it increases the risk of exposure to rising interest rates and can result in funding costs rising faster than asset yields. We expect to limit our interest rate risk by selling a majority of the fixed rate mortgage loans that we originate and retaining for the most part loans with adjustable rate features.

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.

**Results of operations**

We recorded net income of \$1,399,000, or \$0.59 per fully diluted share, in 2006, compared to net income of \$1,231,000, or \$0.61 per fully diluted share, in 2005, and \$862,000, or \$0.45 per fully diluted share, in 2004.

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The significant improvement in our results of operations over the last three years is primarily attributable to the Company's strong growth. Loans and deposits, the primary sources of income and expense for the Company, have grown as follows:

	Loans, net	Deposits
December 31, 2003	\$ 91,522,507	\$ 96,322,607
Growth in 2004		
Amount	42,639,786	43,704,779
Percentage	47%	45%
December 31, 2004	134,162,293	140,027,386
Growth in 2005		
Amount	36,284,980	46,725,421
Percentage	27%	33%
December 31, 2005	170,447,273	186,752,807
Growth in 2006		
Amount	68,051,145	66,557,074
Percentage	40%	36%
December 31, 2006	238,498,418	253,309,881
Three year average growth rate	38%	38%

This growth in loans and deposits resulted in net interest income increasing from \$4,881,000 in 2004, to \$7,048,000 in 2005, and to \$10,233,000 in 2006. As we continue to grow, we expect this trend of increasing net interest income to continue. However, as noted previously, our growth in net interest income could be slowed if the commercial real estate and housing markets should slow down due to the rise in interest rates, higher real estate values or higher home inventory.

Noninterest income declined to \$2,483,000 in 2006 from \$2,890,000 in 2005, a decline of \$407,000, or 14%. This decline was primarily attributable to a decline in the profitability of Village Bank Mortgage. Gain on sale of loans, which is attributable to Village Bank Mortgage's operations, declined from \$1,967,000 in 2005 to \$1,519,000 in 2006, a decline of \$448,000, or 23%. This decline occurred because rising interest rates as well as higher real estate values slowed the sale of homes. The \$2,890,000 in noninterest income in 2005 was a \$1,131,000 increase, or 64%, over the \$1,759,000 in noninterest income in 2004. This increase was also primarily attributable to the operations of Village Bank Mortgage as gain on loan sales increased from \$1,073,000 in 2004 to \$1,967,000 in 2005, an increase of \$894,000, or 83%. The mortgage market was more favorable in 2005 due to lower interest rates and real estate values and because Village Bank Mortgage was able to attract additional loan officers.

Noninterest expense increased from \$5,585,000 in 2004 to \$7,778,000 in 2005, and to \$9,817,000 in 2006. These increases in noninterest expense resulted from the addition of new branches and the growth in the Company overall. The primary increase in noninterest expense over the last three years has come in salaries and benefits, which increased from \$3,108,000 in 2004 to \$4,345,000 in 2005, and to \$5,728,000 in 2006.



Also contributing to the increase in net income in 2004 was the recognition of net deferred tax assets of \$378,000 due to the elimination of the valuation allowance.

### **Interest rate risk**

Profitability may be directly affected by the levels of and fluctuations in interest rates, which affect our ability to earn a spread between interest received on loans and investments and the costs of deposits and borrowings. Our profitability is likely to be adversely affected during any period of unexpected or rapid changes in interest rates. For example, a substantial or sustained increase in interest rates could adversely affect our ability to originate loans and would reduce the value of loans held for sale.

The sale of fixed rate product is intended to protect the Company 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. Decisions to hold or sell adjustable rate mortgage loans are based on the need for such loans in our portfolio, which is influenced by the level of market interest rates and our asset/liability management strategy. As with our 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.

### **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 2006, 2005 and 2004 was \$10,233,000, \$7,048,000, and \$4,881,000, respectively. The increases in net interest income of \$3,185,000, or 45%, in 2006 and \$2,167,000, or 44%, in 2005 are a direct result of increases in loans, from \$170,447,000 at December 31, 2005 to \$238,498,000 at December 31, 2006, an increase of \$68,051,000, or 40%, and from \$134,162,000 at December 31, 2004 to \$170,447,000 at December 31, 2005, an increase of \$36,285,000, or 27%. These increases in loans were funded primarily by increases in deposits. Additionally, our net interest margin has steadily improved over the last three years from 3.88% in 2004 to 4.15% in 2005 to 4.48% in 2006.

Average interest-earning assets in 2006 increased by \$58,753,000, or 35%, compared to 2005. The increase in interest-earning assets from 2005 to 2006 was due primarily to the growth of our loan portfolio. The average yield on interest-earning assets of 8.33% in 2006 was higher than the average yield of 7.03% in 2005. 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 has increased interest rates in 2005 and 2006 the average yield on interest-earning assets increased.

Our interest-bearing liabilities in 2006 increased by \$50,976,000, or 34%, compared to 2005. The growth in those liabilities was due primarily to strong growth in deposits from an average of \$143,485,000 in 2005 to an average of \$193,508,000 in 2006, an increase of \$50,023,000, or 35%. The average cost of interest-bearing liabilities increased to 4.33% in 2006 from 3.21% in 2005. The principal reason for the increase in the liability costs was the increase in short-term rates by the Federal Reserve in 2006. If the Federal Reserve continues to raise short-term interest rates, our cost of interest-bearing liabilities will continue to increase. This also occurred in 2005.

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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 have no tax exempt assets for the periods presented.

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**Average Balance Sheets**  
(In thousands)

	Year Ended December 31, 2006			Year Ended December 31, 2005			Year Ended December 31, 2004		
	Average	Interest	Annualized	Average	Interest	Annualized	Average	Interest	Annualized
	Balance	Income/ Expense	Yield Rate	Balance	Income/ Expense	Yield Rate	Balance	Income/ Expense	Yield Rate
<b>Loans</b>									
Commercial	\$ 17,694	\$ 1,492	8.43%	\$ 46,618	\$ 3,257	6.99%	\$ 37,945	\$ 2,214	5.83%
Real estate - residential	31,713	2,554	8.05%	23,057	1,610	6.98%	14,674	926	6.31%
Real estate - commercial	81,444	6,344	7.79%	33,296	2,651	7.96%	27,253	1,915	7.03%
Real estate - construction	69,038	6,906	10.00%	35,890	2,796	7.79%	28,409	1,957	6.89%
Consumer	6,088	540	8.87%	11,571	884	7.64%	3,548	252	7.10%
Gross loans	205,977	17,836	8.66%	150,432	11,198	7.44%	111,829	7,264	6.50%
Investment securities	8,152	607	7.45%	4,035	139	3.44%	5,474	213	3.89%
Loans held for sale	1,889	126	6.67%	2,740	163	5.95%	1,536	84	5.47%
Federal funds and other	12,377	450	3.64%	12,435	425	3.42%	7,048	89	1.26%
Total interest earning assets	228,395	19,019	8.33%	169,642	11,925	7.03%	125,887	7,650	6.08%
Allowance for loan losses	(2,195)			(1,671)			(1,290)		
Cash and due from banks	5,126			5,694			4,594		
Premises and equipment, net	7,851			6,619			6,108		
Other assets	7,383			4,215			1,659		
Total assets	\$246,560			\$184,499			\$136,958		
<b>Interest bearing deposits</b>									
Interest checking	\$ 7,744	\$ 88	1.14%	\$ 6,850	\$ 52	0.76%	\$ 5,434	\$ 51	0.94%
Money market	21,722	711	3.27%	24,600	622	2.53%	20,721	302	1.46%
Savings	4,124	47	1.14%	4,805	54	1.12%	3,930	44	1.12%
Certificates	159,918	7,432	4.65%	107,230	3,738	3.49%	78,052	2,174	2.79%
Total deposits	193,508	8,278	4.28%	143,485	4,466	3.11%	108,137	2,571	2.38%
<b>Borrowings</b>									
<b>Long-term debt - trust</b>									
preferred securities	5,155	368	7.14%	4,392	239	5.44%	-	-	-
FHLB advances	4,000	126	4.22%	4,000	169	4.23%	4,000	166	4.15%
Other borrowings	374	14	1.77%	184	3	1.63%	1,006	32	3.18%
Total interest bearing liabilities	203,037	8,786	4.33%	152,061	4,877	3.21%	113,143	2,769	2.45%
Noninterest bearing deposits	19,976			14,864			9,401		
Other liabilities	1,270			1,163			384		
Total liabilities	224,283			168,088			122,928		
Equity capital	22,279			16,411			13,439		
Total liabilities and capital	\$246,562			\$184,499			\$136,367		
<b>Net interest income before provision for loan losses</b>									
		\$10,233			\$ 7,048			\$ 4,881	
<b>Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities</b>									
			4.00%			3.82%			3.63%

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

4.48%

4.15%

3.88%

Interest income and interest expense are affected by changes in both average interest rates and average volumes of interest-earning assets and interest-bearing liabilities. The following table analyzes changes in net interest income attributable to changes in the volume of interest-sensitive assets and liabilities compared to changes in interest rates. Nonaccrual loans are included in average loans outstanding. The changes in interest due to both rate and volume have been allocated to changes due to volume and changes due to rate in proportion to the relationship of the absolute dollar amounts of the changes in each.

**Rate/Volume Analysis  
(In thousands)**

	2006 vs. 2005			2005 vs. 2004		
	Increase (Decrease)			Increase (Decrease)		
	Due to Changes in			Due to Changes in		
	Volume	Rate	Total	Volume	Rate	Total
<b>Interest income</b>						
Loans	\$ 4,357	\$ 2,244	\$ 6,601	\$ 2,847	\$ 1,166	\$ 4,013
Investment securities	219	249	468	(52)	(22)	(74)
Fed funds sold and other	(2)	27	25	103	233	336
Total interest income	4,574	2,520	7,094	2,899	1,376	4,275
<b>Interest expense</b>						
Deposits						
Interest checking	7	29	36	4	(3)	1
Money market accounts	(59)	148	89	65	255	320
Savings accounts	(8)	1	(7)	10	0	10
Certificates of deposit	2,201	1,493	3,694	935	629	1,564
Total deposits	2,143	1,669	3,812	1,014	883	1,895
Borrowings						
Long-term debt	19	110	129	239	-	239
FHLB Advances	-	(43)	(43)	-	3	3
Other borrowings	11	-	11	(29)	-	(29)
Total interest expense	2,173	1,736	3,909	1,224	886	2,108
<b>Net interest income</b>	<b>\$ 2,402</b>	<b>\$ 783</b>	<b>\$ 3,185</b>	<b>\$ 1,675</b>	<b>\$ 490</b>	<b>\$ 2,167</b>

**Provision for loan losses**

The provision for loan losses for 2006, 2005 and 2004 was \$796,000, \$461,000, and \$533,000, respectively. The 73% increase in 2006 compared to 2005 is a result of a larger increase in gross loans outstanding in 2006. Gross loans increased by \$68,645,000 in 2006 compared to \$36,738,000 in 2005. The 14% decline in 2005 compared to 2004 is a result of a lower increase in gross loans outstanding in 2005. Gross loans increased by \$36,738,000 in 2005 compared to \$42,942,000 in 2004. 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, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions.

**Noninterest income**

Noninterest income includes service charges and fees on deposit accounts, fee income related to loan origination, and gains and losses on sale of mortgage loans and securities held for sale. Over

the last three years the most significant noninterest income item has been gain on loan sales generated by Village Bank Mortgage, representing 61%, 68% and 61% of total noninterest income in 2004, 2005 and 2006, respectively. Noninterest income amounted to \$1,759,000 in 2004, \$2,890,000 in 2005 and \$2,483,000 in 2006. The increase in noninterest income from 2004 to 2005 of \$1,131,000 and the decrease from 2005 to 2006 of \$407,000 were primarily attributable to the ability of Village Bank Mortgage to generate gains on loan sales. Gains on loan sales increased from \$1,073,000 in 2004 to \$1,967,000 in 2005 and decreased to \$1,519,000 in 2006. The increase in gains on loan sales in 2005 resulted because interest rates were low and the residential real estate market was strong. In 2006, as interest rates continued to increase and real estate values escalated, the residential real estate market slowed down resulting in lower mortgage loan production by Village Bank Mortgage. The mortgage banking business tends to be cyclical and its profitability is dependent on the strength of the residential real estate market.

### **Noninterest expense**

Noninterest expense includes all expenses of the Company with the exception of interest expense on deposits and borrowings, provision for loan losses and income taxes. Some of the primary components of noninterest expense are salaries and benefits, and occupancy and equipment costs. Noninterest expense for the year ended December 31, 2006 was \$9,817,000, an increase of \$2,039,000, or 26%, from the \$7,778,000 recorded in 2005. Salaries and benefits represented the largest increase, increasing from \$4,345,000 in 2005 to \$5,728,000 in 2006, an increase of \$1,383,000, or 31.8%, and representing 68% of the total increase in noninterest expense. This increase in salaries and benefits as well as other increases in noninterest expense was primarily attributable to the growth of the Bank.

Noninterest expense for the year ended December 31, 2005 totaled \$7,778,000, an increase of \$2,193,000, or 39%, from the \$5,585,000 recorded in 2004. Again, salaries and benefits represented the largest increase, increasing by 40% in 2005 to \$4,345,000, compared to \$3,108,000 in 2004. This increase as well as other increases in noninterest expense was primarily attributable to the growth of the Bank and Village Bank Mortgage.

### **Income taxes**

Tax expense in 2006 amounted to \$703,000. This was the first year income tax expense was not reduced by the use of net operating losses from prior years. Income tax expense in 2005 was decreased by \$118,000 related to net operating loss carryforwards from prior years and prior to 2005 no income tax expense was recorded as a result of net operating losses. The Company utilized all its net operating loss carryforwards at December 31, 2005. We recorded an income tax benefit of \$339,000 in 2004 as a result of removing the valuation allowance against net deferred tax assets. This valuation allowance had been established in prior years due to the Company's operating losses.

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 Bank recorded a franchise tax expense of \$122,000, \$120,000 and \$116,000 for 2006, 2005 and 2004, respectively.

### **Loans**

The following tables present the composition of our loan portfolio at the dates indicated and maturities of selected loans at December 31, 2005.





**Loan Portfolio, Net  
(In thousands)**

	December 31,				
	2006	2005	2004	2003	2002
Commercial	\$ 17,889	\$ 14,121	\$ 40,491	\$ 32,822	\$ 24,857
Real estate - residential	36,408	30,043	15,395	14,279	10,642
Real estate - commercial	100,039	66,274	45,121	16,500	6,476
Real estate - construction	80,324	56,146	30,870	25,627	4,579
Consumer	6,730	6,161	4,130	3,836	4,019
<b>Total loans</b>	<b>241,390</b>	<b>172,745</b>	<b>136,007</b>	<b>93,064</b>	<b>50,573</b>
Less: unearned income, net	(339)	(367)	(331)	(404)	(222)
Less: Allowance for loan losses	(2,553)	(1,931)	(1,514)	(1,138)	(755)
<b>Total loans, net</b>	<b>\$ 238,498</b>	<b>\$ 170,447</b>	<b>\$ 134,162</b>	<b>\$ 91,522</b>	<b>\$ 49,596</b>

**Maturities of Selected Loans  
December 31, 2006  
(In thousands)**

	Within 1 Year	Fixed Rate		Total	Variable Rate		Total	Total Maturities
		1 to 5 Years	After 5 Years		1 to 5 Years	After 5 Years		
Commercial	\$10,328	\$ 5,296	\$ 2,097	\$ 7,393	\$ 168	\$ -	\$ 168	\$17,889
Real estate								
Commercial	36,929	5,267	37,026	42,293	20,817	-	20,817	100,039
Construction	73,580	2,766	2,422	5,188	1,556	-	1,556	80,324

**Allowance for loan losses**

The allowance for loan losses at December 31, 2006 was \$2,553,000, compared to \$1,931,000 at December 31, 2005 and \$1,514,000 at December 31, 2004. The ratio of the allowance for loan losses to gross loans was 1.06% at December 31, 2006 and 1.12% at December 31, 2005, and December 31, 2004. 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, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions. We believe the amount of the allowance for loan losses at December 31, 2006 is adequate to absorb the losses that can reasonably be anticipated from the loan portfolio at that date.

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)**

	Year Ended December 31,				
	2006	2005	2004	2003	2002
Beginning balance	\$ 1,931	\$ 1,514	\$ 1,138	\$ 755	\$ 458
Provision for loan losses	796	461	533	399	313
Charge-offs					
Commercial	(183)	-	(89)	(55)	-
Consumer	(72)	(46)	(48)	-	(15)
Mortgage	-	-	(21)	-	(1)
	(255)	(46)	(158)	(55)	(16)
Recoveries					
Commercial	74	-	-	-	-
Consumer	7	2	1	-	-
	81	2	1	-	-
Acquisition of Community First	-	-	-	39	-
Ending balance	\$ 2,553	\$ 1,931	\$ 1,514	\$ 1,138	\$ 755
Loans outstanding at end of year (1)	\$ 241,051	\$ 172,378	\$ 135,676	\$ 92,660	\$ 50,351
Ratio of allowance for loan losses as a percent of loans outstanding at end of year	1.06%	1.12%	1.12%	1.23%	1.50%
Average loans outstanding for the year (1)	\$ 205,978	\$ 150,432	\$ 111,829	\$ 72,169	\$ 40,735
Ratio of net charge-offs to average loans outstanding for the year	0.12%	0.03%	0.14%	0.08%	0.04%

(1) Loans are net of unearned income.

We have allocated the allowance for loan losses according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within each of the categories of loans. The allocation of the allowance as shown in the table below should not be interpreted as an indication that losses in future years will occur in the same proportions or that the allocation indicates future loss trends. Furthermore, the portion allocated to each loan category is not the total amount available for future losses that might occur within such categories since the total allowance is a general allowance applicable to the entire portfolio.

**Allocation of the Allowance for Loan Losses  
(In thousands)**

December 31, 2006		December 31, 2005		December 31, 2004		December 31, 2003		December 31, 2002	
Total	%	Total	%	Total	%	Total	%	Total	%

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Commercial	\$ 377	14.8%	\$ 568	29.5%	\$ 653	43.2%	\$ 571	50.2%	\$ 344	45.6%
Real estate										
Residential	512	20.1%	358	18.5%	97	6.4%	71	6.2%	66	8.7%
Commercial	884	34.5%	444	23.0%	474	31.3%	225	19.8%	135	17.9%
Construction	694	27.2%	485	25.1%	205	13.5%	172	15.1%	83	11.0%
Consumer	86	3.4%	76	3.9%	85	5.6%	99	8.7%	127	16.8%
Total	\$ 2,553	100.0%	\$1,931	100.0%	\$1,514	100.0%	\$1,138	100.0%	\$ 755	100.0%

**Asset quality**

The following table summarizes asset quality information at the dates indicated:

**Asset Quality**  
*(In thousands)*

	December 31,				
	2006	2005	2004	2003	2002
Nonaccrual loans	\$ 2,801	\$ 1,834	\$ 473	\$ 336	\$ 491
Restructured loans	-	-	-	-	-
Foreclosed properties	-	-	-	-	-
Total nonperforming assets	\$ 2,801	\$ 1,834	\$ 473	\$ 336	\$ 491
Loans past due 90 days and still accruing interest (not included in nonaccrual loans above)	\$ 6,520	\$ 4,932	\$ 1,134	\$ 654	\$ 392
Nonperforming assets to loans at end of year (1)	1.16%	1.06%	0.35%	0.36%	0.98%
Allowance for loan losses to nonaccrual loans	91.1%	105.3%	320.1%	338.7%	153.8%

(1) Loans are net of unearned income.

Interest is accrued on outstanding loan principal balances, unless the Company considers collection to be doubtful. Commercial and unsecured consumer loans are designated as non-accrual when payment is delinquent 90 days or at the point which the Company considers collection doubtful, if earlier. Mortgage loans and most other types of consumer loans past due 90 days or more may remain on accrual status if management determines that concern over our ability to collect principal and interest is not significant. When loans are placed in non-accrual status, previously accrued and unpaid interest is reversed against interest income in the current period and interest is subsequently recognized only to the extent cash is received. Interest accruals are resumed on such loans only when in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

At December 31, 2006, the Company had seven loans totaling \$1,242,000 which were considered impaired and have specific allowances for loan losses totaling \$160,000. The gross interest income that would have been earned in 2006 if the loans classified as nonaccrual had been current in accordance with the original terms was \$92,000. Forty loans totaling \$6,520,000 at December 31, 2006 were past due 90 days or more and interest was still being accrued as such amounts were considered collectible.

**Investment portfolio**

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At December 31, 2006, 2005 and 2004, 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 Value	Amortized Cost	Unrealized Gain (Loss)	Estimated Fair Value	Average Yield
<b>December 31, 2006</b>					
US Government Agencies					
Within one year	\$ 605	\$ 597	\$ -	\$ 597	5.22%
One to five years	360	360	(9)	351	4.65%
More than five years	11,789	11,789	(27)	11,762	5.83%
Total	12,754	12,746	(36)	12,710	5.77%
Mortgage-backed securities					
More than five years	77	77	1	78	3.57%
Total investment securities	\$ 12,831	\$ 12,823	\$ (35)	\$ 12,788	5.75%
<b>December 31, 2005</b>					
US Government Agencies					
Within one year	\$ 605	\$ 599	\$ (1)	\$ 598	4.36%
One to five years	360	360	(10)	350	4.65%
More than five years	1,790	1,790	(49)	1,741	4.97%
Total	2,755	2,749	(60)	2,689	4.79%
Mortgage-backed securities					
More than five years	237	238	5	243	3.64%
Other investments					
More than five years	50	50	-	50	3.92%
Total investment securities	\$ 3,042	\$ 3,037	\$ (55)	\$ 2,982	4.69%
<b>December 31, 2004</b>					
US Government Agencies					
Within one year	\$ 1,820	\$ 1,814	\$ (1)	\$ 1,813	2.13%
One to five years	500	513	(8)	505	2.97%
More than five years	2,500	2,500	(49)	2,451	2.82%
Total	4,820	4,827	(58)	4,769	2.57%
Mortgage-backed securities					
More than five years	450	453	10	463	3.62%
Other investments					
Within one year	146	146	-	146	5.50%
More than five years	50	50	-	50	3.92%
Total	196	196	-	196	5.10%
Total investment securities	\$ 5,466	\$ 5,476	\$ (48)	\$ 5,428	2.75%



**Deposits**

The following table gives the composition of our deposits at the dates indicated.

**Deposits**  
*(In thousands)*

	December 31, 2006		December 31, 2005		December 31, 2004	
	Amount	%	Amount	%	Amount	%
Demand accounts	\$ 22,381	8.8%	\$ 16,092	8.6%	\$ 10,031	7.2%
Interest checking accounts	9,415	3.7%	6,665	3.6%	6,453	4.6%
Money market accounts	17,942	7.1%	33,827	18.1%	24,000	17.1%
Savings accounts	4,107	1.6%	4,633	2.5%	4,438	3.2%
Time deposits of \$100,000 and over	66,423	26.2%	38,416	20.6%	31,974	22.8%
Other time deposits	133,042	52.6%	87,120	46.6%	63,131	45.1%
Total	\$ 253,310	100.0%	\$ 186,753	100.0%	\$ 140,027	100.0%

Total deposits increased by 36%, 33% and 45% in 2006, 2005 and 2004, respectively.

The variety of deposit accounts offered by the Company 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 will continue to be, significantly affected by money market conditions.

The following table is a schedule of average balances and average rates paid for each deposit category for the periods presented:

**Average Deposits and Rates Paid**  
*(In thousands)*

Account Type	Year Ended December 31,		2005		2004	
	2006	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing demand accounts	\$ 19,976	-	\$ 14,864	-	\$ 9,401	-

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Interest-bearing deposits						
Interest checking accounts	7,744	1.14%	6,850	0.76%	5,434	0.94%
Money market accounts	21,722	3.28%	24,600	2.53%	20,721	1.46%
Savings accounts	4,124	1.14%	4,805	1.12%	3,930	1.12%
Time deposits of \$100,000 and over	51,654	4.75%	34,519	3.48%	25,857	2.63%
Other time deposits	108,264	4.60%	72,711	3.49%	52,195	2.86%
Total interest-bearing deposits	193,508	4.28%	143,485	3.11%	108,137	2.38%
Total average deposits	\$ 213,484		\$ 158,349		\$ 117,538	

The following table is a schedule of maturities for time deposits of \$100,000 or more at December 31, 2006.

**Maturities of Time Deposits of \$100,000 or More**  
(*In thousands*)

Due within three months	\$ 21,543
Due after three months through six months	15,606
Due after six months through twelve months	11,130
Over twelve months	18,144
	\$ 66,423

**Borrowings**

We utilize 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 \$4,000,000 at December 31, 2006 and 2005. The FHLB advances are secured by the pledge of residential mortgage loans and our FHLB stock. Available borrowings at December 31, 2006 were approximately \$20 million.

Federal funds purchased represent unsecured borrowings from other banks and generally mature daily. We did not have any purchased federal funds at December 31, 2006 or 2005.

**Contractual obligations and other commitments**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve elements of credit risk and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contractual amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

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The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and letters of credit written is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Unless noted otherwise, the Company does not require collateral or other security to support financial instruments with credit risk.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being completely drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

**Capital resources**

Stockholders' equity at December 31, 2006 was \$25,644,000, compared to \$17,152,000 at December 31, 2005 and \$14,985,000 at December 31, 2004. The \$8,492,000 increase in equity during 2006 was due to net income of \$1,399,000 for 2006 and proceeds from the issuance of common stock of \$7,227,000. The proceeds from the issuance of stock was attributable to the exercise of stock warrants and related issuance of common stock discussed in Note 12 of the *Notes to Consolidated Financial Statements* and, to a much lesser extent, the exercise of stock options. The \$2,167,000 increase in equity during 2005 was due to the net income for the year of \$1,231,000 and the proceeds from the issuance of common stock through the exercise of warrants of \$947,000.

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. 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. See Note 14 of the *Notes to Consolidated Financial Statements* for a more detailed discussion of the Trust Preferred Capital Notes.

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

**Analysis of Capital**  
*(In thousands)*

	As of December 31,		
	2006	2005	2004
<b>Tier 1 capital</b>			
Common stock	\$ 10,248	\$ 7,418	\$ 7,047
Additional paid-in capital	13,589	9,192	8,616
Retained earnings (deficit)	1,985	585	(646)
Qualifying trust preferred securities	5,000	5,000	-
Total equity	30,822	22,195	15,017
Less: goodwill	(689)	(689)	(689)
Total Tier 1 capital	30,133	21,506	14,328
<b>Tier 2 capital</b>			
Allowance for loan losses	2,553	1,931	1,514
Total Tier 2 capital	2,553	1,931	1,514
Total risk-based capital	32,686	23,437	15,842
Risk-weighted assets	\$ 275,323	\$ 191,413	\$ 153,020
Capital ratios			
Tier 1 capital to risk-weighted assets	10.8%	11.2%	9.4%
Total capital to risk-weighted assets	11.8%	12.2%	10.4%

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Leverage ratio (Tier 1 capital to average assets)	10.6%	10.0%	9.4%
Equity to total assets	8.8%	8.0%	9.3%

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 December 31, 2006. The well capitalized classification permits financial institutions to minimize the cost of FDIC insurance assessments by being charged a lesser rate than those that do not meet this definition.

## 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 December 31, 2006, cash, cash equivalents and investment securities available-for-sale totaled \$29,986,000, or 10% of total assets.

At December 31, 2006, we had commitments to originate \$97,579,000 of loans. Fixed commitments to incur capital expenditures were less than \$25,000 at December 31, 2006. Certificates of deposit scheduled to mature in the 12-month period ending December 31, 2007 total \$142,069,000. We believe that a significant portion of such deposits will remain with us. We further believe that deposit growth, loan repayments and other sources of funds 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 December 31, 2006. 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**  
**December 31, 2006**  
*(In thousands)*

	Within 3 Months	3 to 6 Months	6 to 12 Months	13 to 36 Months	More than 36 Months	Total
<b>Interest Rate Sensitive Assets</b>						
Loans (1)						
Fixed rate	\$ 7,007	\$ 938	\$ 2,700	\$ 5,565	\$ 30,932	\$ 47,142
Variable rate	131,850	3,714	10,241	13,425	35,018	194,248
Investment securities	597	-	-	-	12,191	12,788
Loans held for sale	3,149	-	-	-	-	3,149
Federal funds sold	11,496	-	-	-	-	11,496
<b>Total rate sensitive assets</b>	<b>154,099</b>	<b>4,652</b>	<b>12,941</b>	<b>18,990</b>	<b>78,141</b>	<b>268,823</b>
<b>Cumulative rate sensitive assets</b>	<b>154,099</b>	<b>158,751</b>	<b>171,692</b>	<b>190,682</b>	<b>268,823</b>	
<b>Interest Rate Sensitive Liabilities</b>						
Interest checking (2)	-	-	-	9,415	-	9,415
Money market accounts	17,942	-	-	-	-	17,942
Savings (2)	-	-	-	4,107	-	4,107
Certificates of deposit	61,208	47,831	33,151	46,886	10,389	199,465
FHLB advances	-	-	-	4,000	-	4,000
Trust Preferred Securities	-	-	-	-	5,155	5,155
Other borrowings	704	-	-	-	-	704
<b>Total rate sensitive liabilities</b>	<b>79,854</b>	<b>47,831</b>	<b>33,151</b>	<b>64,408</b>	<b>15,544</b>	<b>240,788</b>
<b>Cumulative rate sensitive liabilities</b>	<b>79,854</b>	<b>127,685</b>	<b>160,836</b>	<b>225,244</b>	<b>240,788</b>	
<b>Rate sensitivity gap for period</b>	<b>\$ 74,245</b>	<b>\$ (43,179)</b>	<b>\$ (20,210)</b>	<b>\$ (45,418)</b>	<b>\$ 62,597</b>	<b>\$ 28,035</b>
<b>Cumulative rate sensitivity gap</b>	<b>\$ 74,245</b>	<b>\$ 31,066</b>	<b>\$ 10,856</b>	<b>\$ (34,562)</b>	<b>\$ 28,035</b>	
<b>Ratio of cumulative gap to total assets</b>	<b>25.5%</b>	<b>10.7%</b>	<b>3.7%</b>	<b>(11.9)%</b>	<b>9.6%</b>	
<b>Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities</b>	<b>193.0%</b>	<b>124.3%</b>	<b>106.7%</b>	<b>84.7%</b>	<b>111.6%</b>	
<b>Ratio of cumulative gap to cumulative rate sensitive assets</b>	<b>48.2%</b>	<b>19.6%</b>	<b>6.3%</b>	<b>(18.1)%</b>	<b>10.4%</b>	

(1) Includes nonaccrual loans of approximately \$2,801,000, 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.

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At December 31, 2006, our assets that reprice within one year exceeded liabilities that reprice within one year by \$10,856,000 and therefore we were in an asset-sensitive position. A positive gap can adversely affect earnings in periods of falling interest rates. This positive position is due primarily to our adjustable rate loan portfolio.

### Critical accounting policies

The financial condition and results of operations presented in the financial statements, accompanying notes to the financial statements and management's discussion and analysis are, to a large degree, dependent upon the Company's accounting policies. The selection and application of these accounting policies involve judgments, estimates, and uncertainties that are susceptible to change.

Presented below is discussion of those accounting policies that management believes are the most important accounting policies to the portrayal and understanding of our financial condition and results of operations. These critical accounting policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial condition or results of operations is a reasonable likelihood. See also Note 1 of the *Notes to Consolidated Financial Statements*.

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in our 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 and lease portfolio; and the loan grading system.

We evaluate various loans individually for impairment as required by Statement of Financial Accounting Standards (SFAS) 114, *Accounting by Creditors for Impairment of a Loan*, and SFAS 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*. 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. If a loan evaluated individually is not impaired, then the loan is assessed for impairment under SFAS 5, *Accounting for Contingencies*, with a group of loans that have similar characteristics.

For loans without individual measures of impairment, we make estimates of losses for groups of loans as required by SFAS 5. 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 amount of estimated impairment for individually evaluated loans and groups of loans is added together for a total estimate of loans 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.

#### **New accounting standards**

In March 2006, the Financial Accounting Standards Board (the FASB) issued Statement No. 156, *Accounting for Servicing of Financial Assets*, which is an amendment of Statement No. 140, intended to simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Statement No. 156 is effective for years beginning after September 15, 2006, although earlier adoption is permitted. We do not believe Statement No. 156 will be material to the Company's consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48) *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes thresholds and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will become effective January 1, 2007. We do not believe FIN 48 will be material to the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006. SAB 108 did not have a material affect on the Company's consolidated financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. Statement No. 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. While the Statement applies under other accounting pronouncements that require or permit fair value measurements, it does not require any new fair value measurements. Statement No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. In addition, the Statement establishes a fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Lastly, Statement No. 157 requires additional disclosures for each interim and annual period separately for each major category of assets and liabilities. Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not believe Statement No. 157 will be material to the Company's consolidated financial statements.

In September 2006, the FASB issued Statement No. 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106, and 132(R). Statement No. 158 improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. Statement No. 158 also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. Statement No. 158 is effective as of the end of the fiscal year ending after December 15, 2006. The adoption of Statement 158 resulted in the Bank recognizing a liability of approximately \$220,000.

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In February 2007, the FASB issued Statement No. 159 The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115 . Statement No. 159

permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Statement No. 159 is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements. We do not believe Statement No. 159 will be material to the Company's consolidated financial statements.

Other proposals, interpretations of existing pronouncements or FASB staff positions have been recently issued which include the following:

FASB FSP to require recalculation of leveraged leases if the timing of tax benefits affect cash flows;

Emerging Issues Task Force (EITF) Issue No. 06-4 which addresses accounting for deferred compensation and post retirement benefits of endorsement split-dollar life insurance; and

EITF Issue No. 06-5 which encompasses accounting for purchases of life insurance and the ramifications of determining the amount that could be realized in accordance with FASB Technical Bulletin 84-4.

We have not completed our analysis of this new guidance (as proposed, where applicable) although we anticipate their potential impact (if finalized, where applicable) will not be material to the Company's consolidated financial statements. A variety of proposed or otherwise potential accounting standards are currently under study by standardsetting organizations and various regulatory agencies. Because of the tentative and preliminary nature of these proposed standards, we have not determined whether implementation of such proposed standards would be material to the Company's consolidated financial statements.

### **Impact of inflation and changing prices**

The financial statements in this document have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars, without consideration of changes in the relative purchasing power of money over time due to inflation.

Unlike industrial companies, most of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the price of goods and services, since such prices are affected by inflation.

**ITEM 7 FINANCIAL STATEMENTS**

**Audited Financial Statements**

The following 2006 Financial Statements of Village Bank and Trust Financial Corp. are included after the signature pages:

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**ITEM 8 CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 8A CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including 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 pursuant to the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings with the Securities and Exchange Commission.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in the Company's 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.



**ITEM 8B OTHER INFORMATION**

None.

**PART III**

**ITEM 9 DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS, CONTROL PERSONS AND CORPORATE GOVERNANCE;  
COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 9 is contained in the Company's Proxy Statement for the 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

**ITEM 10 EXECUTIVE COMPENSATION**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 10 is contained in the Company's Proxy Statement for the 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

**ITEM 11 SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS  
AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 11 is contained in the Company's Proxy Statement for the 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

**ITEM 12 CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 12 is contained in the Company's Proxy Statement for the 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

**ITEM 13 EXHIBITS**

Exhibit

<u>Number</u>	<u>Description</u>
3.1	Articles of Incorporation of Village Bank and Trust Financial Corp. restated in electronic format only as of May 18, 2005.
3.2	Bylaws of Southern Community Financial Corp., incorporated by reference to Exhibit 3.2 of the Current Report on Form 8-K dated April 30, 2004.
10.1	Incentive Plan, as amended and restated May 23, 2006, incorporated by reference to Exhibit 10.1 of the Quarterly Report on Form 10-QSB for the period ended June 30, 2006. *
10.2	Organizational Investors Warrant Plan, incorporated by reference to Exhibit 10.2 of the Annual Report on Form 10-KSB for the year ended December 31, 2004.
10.3	Shareholder Loan Referral Warrant Plan, incorporated by reference to Exhibit 10.3 of the Annual Report on Form 10-KSB for the year ended December 31, 2004.
10.4	Executive Employment Agreement, effective as of April 1, 2001, between Thomas W. Winfree and Southern Community Bank & Trust, incorporated by reference to Exhibit 10.4 of the Annual Report on Form 10-KSB for the year ended December 31, 2004. *
10.5	Form of Incentive Stock Option Agreement, incorporated by reference to Exhibit 10.5 of the Annual Report on Form 10-KSB for the year ended December 31, 2004. *
10.6	Form of Non-Employee Director Non-Qualified Stock Option Agreement, incorporated by reference to Exhibit 10.6 of the Annual Report on Form 10-KSB for the year ended December 31, 2004. *
21	Subsidiaries of Village Bank and Trust Financial Corp.
31.1	Section 302 Certification by Chief Executive Officer.
31.2	Section 302 Certification by Chief Financial Officer.
32	Section 906 Certification.

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\* Management contracts and compensatory plans and arrangements.



**ITEM 14 PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 14 is contained in the Company's Proxy Statement for the 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

**SIGNATURES**

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**VILLAGE BANK AND TRUST FINANCIAL CORP.**

Date: March 20, 2007  
Thomas W. Winfree

By: /s/ Thomas W. Winfree

President and Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Thomas W. Winfree</u> Thomas W. Winfree	President and Chief Executive Officer and Director (Principal Executive Officer)	March 20, 2007
<u>/s/ C. Harril Whitehurst, Jr.</u> C. Harril Whitehurst, Jr.	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 20, 2007
<u>/s/ R. T. Avery, III</u> R.T. Avery, III	Director	March 20, 2007

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/s/ Donald J. Balzer, Jr. Director and March 20, 2007  
Donald J. Balzer, Jr. Vice Chairman of the Board

/s/ Craig D. Bell Director and March 20, 2007  
Craig D. Bell Chairman of the Board

/s/ William B. Chandler Director March 20, 2007  
William B. Chandler

/s/ R. Calvert Esleeck, Jr. Director March 20, 2007  
R. Calvert Esleeck, Jr.

/s/ Dean Patrick Director March 20, 2007  
Dean Patrick

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<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ George R. Whittemore</u>	Director	March 20, 2007
George R. Whittemore		
<u>/s/ Michael L. Toalson</u>	Director	March 20, 2007
Michael L. Toalson		





Report of Independent Registered Public Accounting Firm

Board of Directors

Village Bank and Trust Financial Corp.

Midlothian, Virginia

We have audited the accompanying consolidated balance sheets of Village Bank and Trust Financial Corp. and Subsidiary as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These consolidated financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Village Bank and Trust Financial Corp. and Subsidiary as of December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

Richmond, Virginia

March 19, 2007

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Balance Sheets**  
**December 31, 2006 and 2005**

	2006	2005
<b>Assets</b>		
Cash and due from banks	\$ 5,702,401	\$ 6,386,324
Federal funds sold	11,496,102	19,442,230
Investment securities available for sale	12,787,644	2,981,903
Loans held for sale	3,149,178	2,860,440
Loans		
Outstandings	241,389,621	172,745,040
Allowance for loan losses	(2,552,607)	(1,930,999)
Unearned income	(338,596)	(366,768)
Loans, net	238,498,418	170,447,273
Premises and equipment, net	11,676,854	7,203,760
Accrued interest receivable	2,301,264	936,589
Goodwill	689,108	689,108
Other assets	4,916,791	4,027,325
	\$ 291,217,760	\$ 214,974,952
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Deposits	\$ 253,309,881	\$ 186,752,807
Federal Home Loan Bank advances	4,000,000	4,000,000
Long-term debt - trust preferred securities	5,155,000	5,155,000
Other borrowings	704,265	486,810
Accrued interest payable	429,986	221,324
Other liabilities	1,974,513	1,207,118
Total liabilities	265,573,645	197,823,059
<b>Stockholders' Equity</b>		
Preferred stock, \$1 par value - 1,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, \$4 par value - 10,000,000 shares authorized; 2,562,088 shares issued and outstanding at December 31, 2006, 1,854,618 shares issued and outstanding at December 31, 2005	10,248,352	7,418,472
Additional paid-in capital	13,588,888	9,191,567
Accumulated other comprehensive income (loss)	(177,759)	(43,562)
Retained earnings	1,984,634	585,416
Total stockholders' equity	25,644,115	17,151,893
	\$ 291,217,760	\$ 214,974,952

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Income**  
**Years Ended December 31, 2006, 2005 and 2004**

	2006	2005	2004
<b>Interest income</b>			
Loans	\$ 17,961,729	\$ 11,360,536	\$ 7,348,033
Investment securities	450,044	139,229	213,027
Federal funds sold and other	607,338	425,368	88,507
Total interest income	19,019,111	11,925,133	7,649,567
<b>Interest expense</b>			
Deposits	8,278,308	4,466,396	2,571,166
Borrowed funds	508,292	410,980	197,675
Total interest expense	8,786,600	4,877,376	2,768,841
<b>Net interest income</b>	10,232,511	7,047,757	4,880,726
Provision for loan losses	796,006	460,861	532,630
Net interest income after provision for loan losses	9,436,505	6,586,896	4,348,096
<b>Noninterest income</b>			
Service charges and fees	582,860	375,928	525,140
Loss on securities, net	-	-	(26,370)
Gain on sale of loans	1,519,442	1,966,854	1,072,708
Other operating income	380,491	547,534	187,930
Total noninterest income	2,482,793	2,890,316	1,759,408
<b>Noninterest expense</b>			
Salaries and benefits	5,727,791	4,344,893	3,108,032
Occupancy	681,477	435,971	302,339
Equipment	516,358	462,898	449,519
Supplies	322,542	343,516	188,737
Professional and outside services	1,029,046	906,278	664,487
Advertising and marketing	384,304	332,746	145,615
Other operating expense	1,155,572	951,702	726,541
Total noninterest expense	9,817,090	7,778,004	5,585,270
Income before income taxes	2,102,208	1,699,208	522,234
Income tax expense (benefit)	702,990	468,025	(339,309)
<b>Net income</b>	\$ 1,399,218	\$ 1,231,183	\$ 861,543
<b>Earnings per share, basic</b>	\$ 0.62	\$ 0.68	\$ 0.50
<b>Earnings per share, diluted</b>	\$ 0.59	\$ 0.61	\$ 0.45

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Stockholders' Equity**  
**and Comprehensive Income**  
**Years Ended December 31, 2006, 2005, and 2004**

			Accumulated			Total
	Number of Shares	Amount	Additional Paid-in Capital	Retained Earnings (Deficit)	Other Comprehensive Income (loss)	
<b>Balance, December 31, 2003</b>	1,710,994	\$ 6,843,976	\$ 8,303,810	\$ (1,507,310)	\$ (50,786)	\$ 13,589,690
Issuance of common stock	50,750	203,000	311,938	-	-	514,938
Net income	-	-	-	861,543	-	861,543
Change in unrealized gain (loss) on securities available for sale					18,988	18,988
Total comprehensive income						880,531
<b>Balance, December 31, 2004</b>	1,761,744	7,046,976	8,615,748	(645,767)	(31,798)	14,985,159
Issuance of common stock	92,874	371,496	575,819			947,315
Net income				1,231,183		1,231,183
Change in unrealized gain (loss) on securities available for sale (net of income taxes of \$4,470)					(11,764)	(11,764)
Total comprehensive income						1,219,419
<b>Balance, December 31, 2005</b>	1,854,618	7,418,472	9,191,567	585,416	(43,562)	17,151,893
Issuance of common stock	707,470	2,829,880	4,374,314			7,204,194
Stock based compensation			23,007			23,007
Net income				1,399,218		1,399,218
Change in unrealized gain (loss) on securities available for sale (net of income taxes of \$4,743)					11,609	11,609
Minimum pension adjustment						

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(net of income taxes of \$75,112)					(145,806)	(145,806)
Total comprehensive income						1,265,021
<b>Balance, December 31, 2006</b>	2,562,088	\$ 10,248,352	\$ 13,588,888	\$ 1,984,634	\$ (177,759)	\$ 25,644,115

*See accompanying notes to consolidated financial statements.*



**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
**Years Ended December 31, 2006, 2005 and 2004**

	2006	2005	2004
<b>Cash Flows from Operating Activities</b>			
Net income	\$ 1,399,218	\$ 1,231,183	\$ 861,543
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	477,517	333,080	336,184
Provision for loan losses	796,006	460,861	532,630
Gain on loans sold	(1,519,442)	(1,966,854)	(1,072,708)
Stock compensation expense	23,007		
Loss on securities	-	-	26,370
Proceeds from sale of mortgage loans	64,268,836	83,331,834	45,447,941
Origination of mortgage loans for sale	(63,038,132)	(81,358,336)	(45,739,320)
Amortization of premiums and accretion of discounts on securities, net	(39,324)	3,241	12,629
Proceeds from sale of insurance business	-	-	127,140
Write-off of goodwill	-	-	118,106
Increase in interest receivable	(1,364,675)	(325,723)	(219,208)
Increase in other assets	(1,042,484)	(2,298,613)	(1,273,746)
Increase in interest payable	208,662	46,170	60,977
Increase in other liabilities	767,395	925,022	53,264
Net cash provided by (used in) operating activities	936,584	381,865	(728,198)
<b>Cash Flows from Investing Activities</b>			
Purchases of available for sale securities	(25,378,394)	(12,158,531)	(5,956,329)
Maturities and calls of available for sale securities	15,630,798	14,594,454	9,116,281
Net increase in loans	(68,847,151)	(36,745,841)	(43,172,416)
Purchases of premises and equipment	(4,950,612)	(1,322,267)	(474,971)
Net cash used in investing activities	(83,545,358)	(35,632,185)	(40,487,435)
<b>Cash Flows from Financing Activities</b>			
Issuance of common stock	7,204,194	947,315	514,938
Net increase in deposits	66,557,074	46,725,421	43,704,779
Proceeds from issuance of trust preferred securities	-	5,155,000	-
Net increase (decrease) in other borrowings	217,455	(348,269)	30,882
Net cash provided by financing activities	73,978,723	52,479,467	44,250,599
Net (decrease) increase in cash and cash equivalents	(8,630,051)	17,229,147	3,034,966
Cash and cash equivalents, beginning of period	25,828,554	8,599,407	5,564,441
Cash and cash equivalents, end of period	\$ 17,198,503	\$ 25,828,554	\$ 8,599,407

*See accompanying notes to consolidated financial statements.*



**Village Bank and Trust Financial Corp. and Subsidiary**

**Notes to Consolidated Financial Statements**

**Years Ended December 31, 2006, 2005 and 2004**

**Note 1. Summary of Significant Accounting Policies**

The accounting and reporting policies of Village Bank and Trust Financial Corp. and subsidiary (the Company) conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. The following is a description of the more significant of those policies:

**Business**

The Company is the holding company of and successor to the Village Bank (the Bank). Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction. In the transaction, the shares of the Bank's common stock were exchanged for shares of the Company's common stock, par value \$4.00 per share (Common Stock), on a one-for-one basis. As a result, the Bank became a wholly owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company. All references to the Company in this annual report for dates or periods prior to April 30, 2004 are references to the Bank.

The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Bank acquired or formed three wholly owned subsidiaries, Village Bank Mortgage Corporation (Village Mortgage), a full service mortgage banking company, Village Insurance Agency, Inc. (Village Insurance), a full service property and casualty insurance agency, and Village Financial Services Corporation (Village Financial Services), a financial services company. Through these subsidiaries, the Bank provides a broad array of financial services to its customers.

The Company is subject to intense competition from existing bank holding companies, commercial banks and savings banks which have been in business for many years and have established customer bases. Competition also comes from a variety of other non-bank businesses that offer financial services. Many of these competitors operate in the same geographic market where the Company operates, are well-known with long-standing relationships with businesses and individuals in the communities, and are substantially larger with greater resources than the Company.

The Bank is also subject to regulations of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities. As a consequence of the extensive regulation of commercial banking activities, the Bank's business is susceptible to being affected by state and federal legislation and regulations.

The majority of the Company's real estate loans are collateralized by properties in markets in the Richmond, Virginia metropolitan area. Accordingly, the ultimate collectibility of those loans collateralized by real estate is particularly susceptible to changes in market conditions in the Richmond area.

### **Basis of Presentation and Consolidation**

The consolidated financial statements include the accounts of the Company, the Bank and the Bank's subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

### **Use of estimates**

The preparation of the 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 dates 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.

### **Investment securities**

At the time of purchase, debt securities are classified into the following categories: held-to-maturity, available-for-sale or trading. Debt securities that the Company has both the positive intent and ability to hold to maturity are classified as held-to-maturity. Held-to-maturity securities are stated at amortized cost adjusted for amortization of premiums and accretion of discounts on purchase using a method that approximates the effective interest method. Investments classified as trading or available-for-sale are stated at fair market value. Changes in fair value of trading investments are included in current earnings while changes in fair value of available-for-sale investments are excluded from current earnings and reported, net of taxes, as a separate component of stockholders' equity. Presently, the Company does not maintain a portfolio of trading securities.

A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. No such declines have occurred.

Interest income is recognized when earned. Realized gains and losses for securities classified as available-for-sale and held-to-maturity are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

### **Loans held for sale**

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The Company, through the Bank's mortgage banking subsidiary, Village Bank Mortgage, originates residential mortgage loans for sale in the secondary market. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an individual loan basis as determined by outstanding commitments from investors or current investor yield requirements for loans of similar quality and type. The Company requires a firm purchase commitment from a permanent investor before a loan can be closed, thus limiting interest rate risk. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Residential mortgage loans held for sale are sold to the permanent investor with the mortgage servicing rights released. Gains or losses on sales of mortgage loans are recognized based on

the difference between the selling price and the carrying value of the related mortgage loans sold. This difference arises primarily as a result of the value of the mortgage servicing rights.

Once a residential mortgage loan is sold to a permanent investor, the Company has no further involvement or retained interest in the loan. There are limited circumstances in which the permanent investor can contractually require the Company to repurchase the loan. The Company makes no provision for any such recourse related to loans sold as history has shown repurchase of loans under these circumstances has been remote.

#### **Rate lock commitments**

The Company, through the Bank's mortgage banking subsidiary, Village Bank Mortgage, enters into commitments to originate residential mortgage loans in which the interest rate on the loan is determined prior to funding, termed rate lock commitments. Such rate lock commitments on mortgage loans to be sold in the secondary market are considered to be derivatives and must be accounted for as such. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 30 to 120 days. The Company protects itself from changes in interest rates during this period by requiring a firm purchase agreement from a permanent investor before a loan can be closed. As a result, the Company is not exposed to losses nor will it realize gains or losses related to its rate lock commitments due to changes in interest rates.

#### **Loans**

Loans are stated at the principal amount outstanding, net of unearned income. Loan origination fees and certain direct loan origination costs are deferred and amortized to interest income over the life of the loan as an adjustment to the loan's yield over the term of the loan.

Interest is accrued on outstanding principal balances, unless the Company considers collection to be doubtful. Commercial and unsecured consumer loans are designated as non-accrual when payment is delinquent 90 days or at the point which the Company considers collection doubtful, if earlier. Mortgage loans and most other types of consumer loans past due 90 days or more may remain on accrual status if management determines that concern over our ability to collect principal and interest is not significant. When loans are placed in non-accrual status, previously accrued and unpaid interest is reversed against interest income in the current period and interest is subsequently recognized only to the extent cash is received. Interest accruals are resumed on such loans only when in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

#### **Allowance for loan losses**

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can reasonably be anticipated. The allowance is increased by provisions charged to operations and reduced by net charge-offs. Loan performance is reviewed regularly by loan officers and senior management. Management believes the allowance for loan losses is adequate to absorb losses in the loan portfolio.

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The allowance for loan losses is established by charges to operations based on management's evaluation of loans, economic conditions and other factors considered necessary to maintain the allowance at a level adequate to absorb possible losses. When collateral is considered in



determining potential losses, fair value is based upon recent appraisals and evaluations of other factors. The allowance for loan losses is based on estimates and ultimate losses may vary from the current estimates. These estimates are reviewed periodically and adjusted as necessary. In addition, the Bank's regulatory agencies, as an integral part of their examination process, periodically review the allowance for possible loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments of information available to them at the time of their examination.

In addition, the Company evaluates its loans for impairment. A loan is considered to be impaired when it is probable that the Company will be unable to collect all principal and interest amounts according to the contractual terms of the loan agreement. The entire loan portfolio is regularly reviewed by management to identify impaired loans. Such review includes the maintenance of a current classified and criticized loan list and the regular reporting of delinquent loans to management.

The allowance for loan losses related to loans identified as impaired is primarily based on the excess of the loan's current outstanding principal balance over the estimated fair market value of the related collateral. For impaired loans that are not collateral dependent, the allowance for loan losses is recorded at the amount by which the outstanding recorded principal balance exceeds the current best estimate of the future cash flows on the loan, discounted at the loan's effective interest rate.

#### **Premises and equipment**

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation of buildings and improvements is computed using the straight-line method over the estimated useful lives of the assets of 39 years. Depreciation of equipment is computed using the straight-line method over the estimated useful lives of the assets ranging from 3 to 7 years. Amortization of premises (leasehold improvements) is computed using the straight-line method over the term of the lease or estimated lives of the improvements, whichever is shorter.

#### **Goodwill**

Goodwill, which represents the excess of purchase price over fair value of net assets acquired, is evaluated at least annually for impairment by comparing its fair value with its recorded amount and is written down when appropriate. Projected net operating cash flows are compared to the carrying amount of the goodwill recorded and if the estimated net operating cash flows are less than the carrying amount, a loss is recognized to reduce the carrying amount to fair value.

In February 2004, the Company sold the insurance business of Chippenham Insurance. When the Company acquired Chippenham Insurance in 2003, it recorded goodwill of \$245,246. As a result of the sale, the Company recognized a loss of \$118,106 in 2004 representing the difference between the expected proceeds from the sale and the carrying value of the goodwill.

#### **Income taxes**

Deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted tax rates applicable to future years to differences between the financial

statement carrying amounts and the tax bases of existing assets and liabilities. The effect on recorded deferred income taxes of a change in tax laws or rates is recognized in income in the period that includes the enactment date. To the extent that available evidence about the future raises doubt about the realization of a deferred income tax asset, a valuation allowance is established. The primary temporary differences are the allowance for loan losses and depreciation and amortization.

#### **Consolidated statements of cash flows**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, due from banks (including cash items in process of collection), interest-bearing deposits with banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods. Cash flows from loans originated by the Bank and deposits are reported net. The Company paid interest of \$8,578,000, \$4,831,000 and \$2,708,000 in 2006, 2005, and 2004, respectively. The Company paid income taxes of \$986,000 and \$482,000 in 2006 and 2005, respectively, and did not pay any income taxes in 2004.

#### **Comprehensive income**

SFAS 130, *Reporting Comprehensive Income*, established standards for reporting and display of comprehensive income, its components and accumulated balances. Comprehensive income is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. Among other disclosures, SFAS 130 requires that all items that are required to be recognized under current accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements.

#### **Earnings per common share**

Basic earnings per common share is computed by dividing the net earnings by the weighted-average number of common shares outstanding during the period, which totaled 2,269,092, 1,800,061 and 1,724,832 during 2006, 2005 and 2004, respectively. Diluted earnings per share reflects the potential dilution of securities that could share in the net earnings of the Company. Outstanding options and warrants to purchase Common Stock (see Notes 12 and 13) were considered in the computation of diluted earnings per share for the years presented. For the years ended December 31, 2006, 2005 and 2004, the weighted average number of common shares on a fully diluted basis totaled 2,368,686, 2,010,152 and 1,927,004, respectively.

#### **Stock warrant and incentive plans**

On March 21, 2000, the Company approved the Organizational Investors Warrant Plan which made available 140,000 warrants for grant to the Company's initial (organizational) investors for certain risks associated with the establishment of the Bank. The warrants have an exercise price of \$10 per share (which approximated the fair value per share of common stock at issuance date) and expire in April 2008. At December 31, 2006, 140,000 warrants had been issued and none had been exercised.

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In September and October 2002, the Company completed an offering of units, each of which consisted of one share of its common stock and one warrant to purchase one share of its common stock, through the sale of 817,200 units at a price of \$8.50 per unit. Proceeds to the

Company from the offering (net of offering expenses of \$624,000) were \$6,322,000. The share of common stock and warrant that comprised each unit traded together for 45 days after the offering, but subsequently traded separately. The Company also issued 40,860 warrants to the underwriter of the offering. Each warrant entitled the holder to purchase one share of common stock, at a price of \$10.20 per share, at any time through September 27, 2007, unless the warrants were cancelled. The warrants could be cancelled after December 31, 2003 by the Company in whole or in part upon 30 days written notice if for 20 or more trading days within any period of 30 consecutive trading days, including the last day of the period, the bid price of the stock exceeds \$12.75 per share. On April 26, 2006, the Company announced that it would be canceling these warrants effective June 13, 2006 under this provision of the agreement covering the warrants and, on June 13, 2006, the warrants that were not exercised following this announcement were canceled. The cancellation of the common stock warrants resulted in the issuance of 672,638 shares of common stock and the addition of \$6,860,908 in capital in the second quarter of 2006.

The Company has a stock incentive plan which authorizes the issuance of up to 455,000 shares of common stock (increased from 255,000 shares by amendment to the Incentive Plan approved by the Company's shareholders at its 2006 annual meeting on May 23, 2006) to assist the Company in recruiting and retaining key personnel. See Note 13 for more information on the stock incentive plan.

#### **Fair values of financial instruments**

The Bank uses the following methods and assumptions in estimating fair values of financial instruments (see Note 16):

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

*Investment securities* The fair value of investment securities held-to-maturity and available-for-sale is estimated based on bid quotations received from independent pricing services. 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 FHLB borrowings is based on the discounted value of contractual cash flows using the rates currently offered for borrowings of similar remaining maturities. The carrying amounts of federal funds purchased approximate their fair values. Other borrowings are short-term in nature and the carrying amounts approximate fair value.



*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 December 31, 2006. 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.

### **New accounting pronouncements**

In March 2006, the Financial Accounting Standards Board (the FASB) issued Statement No. 156, *Accounting for Servicing of Financial Assets*, which is an amendment of Statement No. 140, intended to simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Statement No. 156 is effective for years beginning after September 15, 2006, although earlier adoption is permitted. We do not believe Statement No. 156 will be material to the Company's consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48) *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes thresholds and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will become effective January 1, 2007. We do not believe FIN 48 will be material to the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006. SAB 108 did not have a material affect on the Company's consolidated financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. Statement No. 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. While the Statement applies under other accounting pronouncements that require or permit fair value measurements, it does not require any new fair value measurements. Statement No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. In addition, the Statement establishes a fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Lastly, Statement No. 157 requires additional disclosures for each interim and annual period separately for each major category of assets and liabilities. Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not believe Statement No. 157 will be material to the Company's consolidated financial statements.

In September 2006, the FASB issued Statement No. 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106, and 132(R). Statement No. 158 improves financial reporting by requiring an employer





to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. Statement No. 158 also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. Statement No. 158 is effective as of the end of the fiscal year ending after December 15, 2006. The adoption of Statement 158 resulted in the Bank recognizing a liability of approximately \$220,000.

In February 2007, the FASB issued Statement No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115*. Statement No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Statement No. 159 is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurements*. We do not believe Statement No. 159 will be material to the Company's consolidated financial statements.

Other proposals, interpretations of existing pronouncements or FASB staff positions have been recently issued which include the following:

- FASB FSP to require recalculation of leveraged leases if the timing of tax benefits affect cash flows;

- Emerging Issues Task Force (EITF) Issue No. 06-4 which addresses accounting for deferred compensation and post retirement benefits of endorsement split-dollar life insurance; and

- EITF Issue No. 06-5 which encompasses accounting for purchases of life insurance and the ramifications of determining the amount that could be realized in accordance with FASB Technical Bulletin 84-4.

We have not completed our analysis of this new guidance (as proposed, where applicable) although we anticipate their potential impact (if finalized, where applicable) will not be material to the Company's consolidated financial statements. A variety of proposed or otherwise potential accounting standards are currently under study by standardsetting organizations and various regulatory agencies. Because of the tentative and preliminary nature of these proposed standards, we have not determined whether implementation of such proposed standards would be material to the Company's consolidated financial statements.

**Note 2. Investment securities available-for-sale**

The amortized cost and estimated fair value of investment securities available-for-sale as of December 31, 2006 and 2005 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31,				
2006				
U.S. Government	\$ 12,746,726	\$ -	\$ (36,435)	\$ 12,710,291
agencies				
Mortgage-backed				
securities	76,668	685	-	77,352
Other investments	-	-	-	-
Total	\$ 12,823,394	\$ 685	\$ (36,435)	\$ 12,787,644
December 31,				
2005				
U.S. Government				
agencies	\$ 2,748,339	\$ -	\$ (59,918)	\$ 2,688,421
Mortgage-backed				
securities	238,019	5,439	-	243,458
Other investments	50,117	-	(93)	50,024
Total	\$ 3,036,475	\$ 5,439	\$ (60,011)	\$ 2,981,903

Investment securities with book values of \$1,597,316 and \$1,598,929 at December 31, 2006 and 2005, respectively, were pledged to secure municipal deposits.

The amortized cost and estimated fair value of investment securities available-for-sale as of December 31, 2006, by contractual maturity, are as follows:

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	Amortized Cost	Estimated Fair Value
Within one year	\$ 597,317	\$ 597,231
One to five years	360,000	351,144
More than five years	11,866,077	11,839,269
Total	\$ 12,823,394	\$ 12,787,644

During 2006 and 2005, investment securities available-for-sale totaling \$15,631,000 and \$14,594,000, respectively, were called or matured with no net losses.

**Note 3. Loans**

Loans classified by type as of December 31, 2006 and 2005 are as follows:

	2006	2005
Commercial	\$ 17,888,875	\$ 14,120,958
Real estate - residential	36,407,536	30,042,905
Real estate - commercial	100,038,902	66,273,903
Real estate - construction	80,323,784	56,146,378
Consumer	6,730,524	6,160,896
Total loans	241,389,621	172,745,040
Less: unearned income, net	(338,596)	(366,768)
Less: Allowance for loan losses	(2,552,607)	(1,930,999)
	\$238,498,418	\$170,447,273

Gross gains on the sale of loans totaling approximately \$1,519,000, \$1,967,000 and \$1,073,000 were realized during the years ended December 31, 2006, 2005 and 2004, respectively.

Forty loans totaling \$6,520,000 at December 31, 2006 were past due 90 days or more yet interest was still being accrued.

The following is a summary of loans directly or indirectly with executive officers or directors of the Company for the years ended December 31, 2006 and 2005:

	2006	2005
Beginning balance	\$ 3,808,341	\$ 3,866,939
Additions	7,476,377	5,066,108
Reductions	7,032,593	5,124,606
Ending balance	\$ 4,252,125	\$ 3,808,441

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Executive officers and directors also had unused credit lines totaling \$4,982,000 and \$2,022,000 at December 31, 2006 and 2005, respectively. All loans and credit lines to executive officers and directors were made in the ordinary course of business at the Company's normal credit terms, including interest rate and collateralization prevailing at the time for comparable transactions with other persons.

**Note 4. Allowance for loan losses**

Activity in the allowance for loan losses in 2006, 2005 and 2004 was as follows:

	2006	2005	2004
Beginning balance	\$ 1,891,582	\$ 1,474,613	\$ 1,098,378
Provision for loan losses	796,006	460,861	532,630
Charge-offs	(255,616)	(45,651)	(158,194)
Recoveries	81,218	1,760	1,799
Ending balance	\$ 2,513,191	\$ 1,891,582	\$ 1,474,613

As of December 31, 2006 and 2005, the Company had impaired loans of \$1,242,000 and \$731,000, respectively, which were on nonaccrual status. These loans had valuation allowances of \$160,000 and \$223,000 as of December 31, 2006 and 2005, respectively. The Company does not record interest income on impaired loans. Interest income that would have been recorded had impaired loans been performing would have been \$77,000, \$91,000 and \$60,000 for 2006, 2005 and 2004, respectively.

**Note 5. Premises and equipment**

The following is a summary of premises and equipment as of December 31, 2006 and 2005:

	2006	2005
Land	\$ 5,122,047	\$ 2,758,965
Buildings and improvements	5,670,486	3,823,227
Furniture, fixtures and equipment	3,167,597	2,470,222
Total premises and equipment	13,960,130	9,052,414
Less: Accumulated depreciation and amortization	(2,283,276)	(1,848,654)
Premises and equipment, net	\$ 11,676,854	\$ 7,203,760

Depreciation and amortization of premises and equipment for 2006, 2005 and 2004 amounted to \$478,000, \$333,000 and \$336,000 respectively.

**Note 6. Investment in Bank Owned Life Insurance**

The Bank is owner and designated beneficiary on life insurance policies in the face amount of \$15,964,000 covering certain of its directors and executive officers. The earnings from these policies are used to offset expenses related to retirement plans. The cash surrender value of these policies at December 31, 2006 and 2005 was \$2,608,000 and \$1,455,000, respectively, and was included in other assets.

**Note 7. Deposits**

Deposits as of December 31, 2006 and 2005 were as follows:

	2006	2005
Demand accounts	\$ 22,381,251	\$ 16,092,167
Interest checking accounts	9,414,544	6,664,602
Money market accounts	17,941,941	33,827,042
Savings accounts	4,106,949	4,633,280
Time deposits of \$100,000 and over		3
	66,423,181	8,415,949
Other time deposits	133,042,015	87,119,767
Total	\$ 253,309,881	\$ 186,752,807

The following are the scheduled maturities of time deposits as of December 31, 2006:

Year Ending December 31,	Less Than \$100,000	Greater than or Equal to \$100,000	Total
2007	\$ 93,789,992	\$ 48,278,638	\$ 142,068,630
2008	7,354,134	2,830,053	10,184,187
2009	26,000,773	10,822,603	36,823,376
2010	3,152,349	2,732,137	5,884,486
2011	2,744,767	1,759,750	4,504,517
	\$ 133,042,015	\$ 66,423,181	\$ 199,465,196

Deposits held at the Company by related parties, which include officers, directors, greater than 5% shareholders and companies in which directors of the Board have a significant ownership interest, approximated \$2,138,000 and \$1,807,000 at December 31, 2006 and 2005, respectively.



**Note 8. Borrowings**

The Company uses both short-term and long-term borrowings to supplement deposits when they are available at a lower overall cost to the Company or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank of Atlanta, the Bank is required to own capital stock in the FHLB and is authorized to apply for advances 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. The FHLB borrowings are secured by the pledge of U.S. Government agency securities, FHLB stock and qualified single family first mortgage loans. The FHLB advances held at December 31, 2006 mature \$2,000,000 on May 24, 2007 and \$2,000,000 on March 11, 2008.

The Company uses federal funds purchased for short-term borrowing needs. Federal funds purchased represent unsecured borrowings from other banks and generally mature daily.

Information related to borrowings is as follows:

	Year Ended December 31,	
	2006	2005
Maximum outstanding during the year		
FHLB advances	\$ 4,000,000	\$ 4,000,000
Federal funds purchased	6,476,000	1,985,000
Balance outstanding at end of year		
FHLB advances	4,000,000	4,000,000
Federal funds purchased	-	-
Average amount outstanding during the year		
FHLB advances	4,000,000	4,000,000
Federal funds purchased	196,633	46,408
Average interest rate during the year		
FHLB advances	3.15%	4.22%
Federal funds purchased	5.67%	3.49%
Average interest rate at end of year		
FHLB advances	4.86%	4.36%
Federal funds purchased	-	-

**Note 9. Income taxes**

The following summarizes the tax effects of temporary differences which compose net deferred tax assets and liabilities at December 31, 2006, 2005 and 2004:

	2006	2005	2004
Deferred tax			
assets			
Allowance for loan			
losses	\$ 815,466	\$ 582,280	\$ 425,588
Unrealized loss on			

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available-for-sale			
securities	10,864	14,811	16,381
Pension expense	75,112	-	-
Goodwill	3,864	2,055	10,184
Total deferred tax			
assets	905,306	599,146	452,153
Deferred tax			
liabilities			
Depreciation	216,605	213,233	68,981
Unrealized gain on			
available-for-sale			
securities	-	-	-
Goodwill	-	-	-
Other, net	9,831	7,610	5,548
Total deferred tax			
liabilities	226,435	220,843	74,529
Net deferred tax			
asset	\$ 678,871	\$ 378,303	\$ 377,624

The income tax expense (benefit) charged to operations for the years ended December 31, 2006, 2005 and 2004 consists of the following:

	2006	2005	2004
Current tax			
expense	\$ 932,392	\$ 613,249	\$ 21,934
Deferred tax benefit	(229,402)	(145,224)	(361,243)
Provision (benefit)			
for income taxes	\$ 702,990	\$ 468,025	\$ (339,309)

A reconciliation of income taxes computed at the federal statutory income tax rate to total income taxes is as follows for the years ended December 31, 2006, 2005 and 2004:

	2006	2005	2004
Income before			
income taxes	\$ 2,102,209	\$ 1,699,208	\$ 522,234
Computed			
"expected" tax			
expense	\$ 714,751	\$ 577,731	\$ 177,560
Cash surrender			
value	(17,764)	(18,788)	-
Nondeductible			
expenses	14,222	11,245	7,200
Alternative			
minimum tax	-	-	21,934
Net operating			
loss carryforward	-	(118,006)	(184,760)
Valuation reserve	-	-	(361,243)
Other	(8,219)	15,843	-

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Provision (benefit)

for income taxes	\$ 702,990	\$ 468,025	\$ (339,309)
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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 \$122,000, \$120,000 and \$116,000 for 2006, 2005 and 2004, respectively.

### **Note 10. Lease commitments**

Certain premises and equipment are leased under various operating leases. Total rent expense charged to operations was \$348,000, \$235,000 and \$196,000 in 2006, 2005 and 2004, respectively. At December 31, 2006, the minimum total rental commitment under such non-cancelable operating leases was as follows:

2007	\$ 403,500
2008	284,600
2009	196,800
2010	183,500
2011	172,600
	\$ 1,241,000

**Note 11. Commitments and contingencies**

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the financial statements. The contract amounts of these instruments reflect the extent of involvement that the Company has in particular classes of instruments.

The Company's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit, and to potential credit loss associated with letters of credit issued, is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for loans and other such on-balance sheet instruments.

At December 31, 2006, the Company had outstanding the following approximate off-balance-sheet financial instruments whose contract amounts represent credit risk:

	Contract Amount
Undisbursed credit lines	\$ 64,034,000
Commitments to extend or originate credit	30,072,000
Standby letter of credit	3,473,000
 Total commitments to extend credit	 \$ 97,579,000

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. Historically, many commitments expire without being drawn upon; therefore, the total commitment amounts shown in the above table are not necessarily indicative of future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, as deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include personal or income-producing commercial real estate, accounts receivable, inventory and equipment.

*Concentrations of credit risk* All of the Company's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Company's market area. Although the Company is building a diversified loan portfolio, a substantial portion of its clients' ability to honor contracts is reliant upon the economic stability of the Richmond, Virginia area, including the real estate markets in the area. The concentrations of credit by type of loan are set forth in Note 3. The distribution of commitments to extend credit approximates the distribution of loans outstanding.



**Note 12. Stockholders' equity and regulatory matters**

In September and October 2002, the Company completed an offering of its common stock through the sale of 817,200 shares at a price of \$8.50 per share. Proceeds to the Company from the offering (net of offering expenses of \$624,000) were \$6,322,000. Attached to each share was a warrant to purchase one share of common stock, at a price of \$10.20 per share, at any time through September 27, 2007, unless the warrants are cancelled. The warrants may be cancelled after December 31, 2003 by the Company in whole or in part upon 30 days' written notice if for 20 or more trading days within any period of 30 consecutive trading days, including the last day of the period, the bid price of the stock exceeds \$12.75 per share. The Company also issued 40,860 warrants to the underwriter of the offering. On April 26, 2006, the Company announced that it would be cancelling these warrants effective June 13, 2006 under this provision of the agreement covering the warrants and, on June 13, 2006, the warrants that were not exercised following this announcement were canceled. The cancellation of the common stock warrants resulted in the issuance of 672,638 shares of common stock and the addition of \$6,860,908 in capital in the second quarter of 2006.

The Organizational Investors Warrant Plan made available 140,000 warrants for grant to the Company's initial (organizational) investors for certain risks associated with the establishment of the Bank. The warrants have an exercise price of \$10 per share (which approximates the fair value per share of common stock at issuance date) and expire in April 2008. At December 31, 2006, 140,000 warrants had been issued and none had been exercised.

The Bank is subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under the capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures are established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 Capital to average assets (the Leverage ratio). Management believes that as of December 31, 2006, the Bank meets all capital adequacy requirements to which it is subject.

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 December 31, 2006. The well capitalized classification permits financial institutions to minimize the cost of FDIC insurance assessments by being charged a lesser rate than those that do not meet this definition.



The Bank's capital amounts and ratios at December 31, 2006 and 2005 are presented in the table below:

	Actual Amount	Ratio	For Capital Adequacy Purposes		To be Well Capitalized	
			Amount	Ratio	Amount	Ratio
<b>December 31, 2006</b>						
Total capital						
(to risk-weighted assets)						
Consolidated	\$ 32,686,000	11.75%	\$ 22,247,000	8.00%	\$ 27,809,000	10.00%
Village Bank	30,624,000	11.12%	22,026,000	8.00%	27,532,000	10.00%
Tier 1 capital (to						
risk-weighted assets)						
Consolidated	30,133,000	10.84%	11,124,000	4.00%	16,685,000	6.00%
Village Bank	28,071,000	10.20%	11,013,000	4.00%	16,519,000	6.00%
Leverage ratio (Tier 1						
capital to average						
assets)						
Consolidated	30,133,000	10.58%	11,268,000	4.00%	14,086,000	5.00%
Village Bank	28,071,000	9.96%	11,268,000	4.00%	14,086,000	5.00%
<b>December 31, 2005</b>						
Total capital (to risk-weighted assets)						
Consolidated	\$ 23,437,000	12.23%	\$ 15,313,000	8.00%	\$ 19,141,000	10.00%
Village Bank	22,261,000	11.64%	15,301,000	8.00%	19,126,000	10.00%
Tier 1 capital (to						
risk-weighted assets)						
Consolidated	21,506,000	11.22%	7,657,000	4.00%	11,485,000	6.00%
Village Bank	20,330,000	10.63%	7,650,000	4.00%	11,475,000	6.00%
Leverage ratio (Tier 1						
capital to average						
assets)						
Consolidated	21,506,000	10.03%	8,574,000	4.00%	10,717,000	5.00%
Village Bank	20,330,000	9.48%	8,574,000	4.00%	10,717,000	5.00%

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In addition, banking regulations limit the amount of cash dividends that may be paid without prior approval of the Bank's regulatory agencies. Such dividends are limited to the lesser of the Bank's retained earnings or the net income of the previous two years combined with the current year net income.

**Note 13. Stock incentive plan**

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

	Options	Weighted Average Exercise Price	Fair Value Per Share
Options outstanding January 1, 2004			
	160,900	\$ 8.44	\$ 4.38
Granted	37,850	12.16	4.73
Forfeited	(1,340)	9.86	4.77
Exercised	-	-	
Options outstanding December 31, 2004			
	197,410	9.14	4.44
Granted	44,250	12.74	4.58
Forfeited	-	-	
Exercised	-	-	
Options outstanding December 31, 2005			
	241,660	9.80	4.47
Granted	16,500	12.50	7.35
Forfeited	(250)	11.77	5.27
Exercised	(6,000)	8.20	3.93

Options outstanding December 31, 2006

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251,910	10.22	\$ 4.67
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Options exercisable December 31, 2006

235,410

Options exercisable December 31, 2005

241,660

Prior to January 1, 2006, the Company applied Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees ( APB 25 ), in accounting for stock options granted to employees and directors pursuant to the Incentive Plan. Under APB 25, compensation expense was determined based upon the fair value of the awards at the grant date consistent with the method under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ), and the impact of this expense on net income and earnings per share was disclosed in the notes to financial statements. Effective January 1, 2006, the Company adopted SFAS No. 123 (Revised 2004),

Share-Based Payment, issued in December 2004, a revision of SFAS 123, and superseding APB 25, and its related implementation guidance. SFAS 123 (Revised 2004) requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost is recognized over the period during which an employee is required to provide service in exchange for the award rather than disclosed in the financial statements. During the year ended December 31, 2006, the Company granted 16,500 stock options to executive officers, the expense of which was not material to the results of operations for the period then ended.

The fair value of each option granted is estimated on the date of grant using the Black-Sholes option pricing model with the following assumptions used for grants for the years indicated:

	Year Ended December 31,		
	2006	2005	2004
Risk-free interest rate	4.99%	4.30%	4.00%
Dividend yield	0%	0%	0%
Expected weighted average term	7 years	7 years	7 years
Volatility	50%	25%	25%

The following table summarizes information about stock options outstanding at December 31, 2006:

Range of Exercise Prices	Outstanding		Exercisable		
	Number of Options	Weighted Average Remaining Years of Contractual Life	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
\$7.68 - \$9.24	154,060	5.5	\$ 8.78	154,060	\$ 8.78
\$11.20 - \$13.00	97,850	8.3	12.47	81,350	12.57
	251,910			235,410	

As of December 31, 2006, there was \$92,133 of total unrecognized compensation cost related to nonvested share based compensation arrangements granted under the Incentive Plan. That cost is expected to be recognized over a weighted average period of 2.4 years. The total fair value of shares vested during the years ended December 31, 2006, 2005 and 2004 was \$23,007, \$202,834, and \$178,866, respectively. There were no stock option forfeitures in 2006.

**Note 14. 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 was 7.51% and 6.64% at December 31, 2006 and 2005, respectively. The securities may be redeemed at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. 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.

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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 15. Retirement plans**

**401K Plan:** The Bank provides a qualified 401K plan to all eligible employees which is administered through the Virginia Bankers Association Benefits Corporation. Employees are eligible to participate in the plan after three months of employment. Eligible employees may, subject to statutory limitations, contribute a portion of their salary to the plan through payroll deduction. The Bank provides a matching contribution of \$.50 for every \$1.00 the participant contributes up to the first 4% of their salary. Participants are fully vested in their own contributions and vest equally over three years of service in the Bank's matching contributions. Total contributions to the plan for the years ended December 31, 2006, 2005 and 2004 were \$76,591, \$48,228 and \$13,359, respectively.

**Supplemental Executive Retirement Plan:** The Bank established the Village Bank Supplemental Executive Retirement Plan (the SERP) on January 1, 2005 to provide supplemental retirement income to certain executive officers as designated by the Personnel Committee and approved by the Board of Directors. The SERP is an unfunded employee pension plan under the provisions of ERISA. An eligible employee, once designated by the Committee and approved by the Board of Directors in writing to participate in the SERP, becomes a participant in the SERP 60 days following such approval (unless an earlier participation date is approved). There are currently four executive officers who participate in the SERP. The retirement benefit to be received by a participant is determined by the Committee and approved by the Board of Directors and is payable in equal monthly installments over a 15 year period, commencing on the first day of the month following a participant's retirement or termination of employment, provided the participant has been employed by the Bank for a minimum of 10 years (6 years in the case of one participant). The Personnel Committee, in its sole discretion, may choose to treat a participant who has experienced a termination of employment on or after attaining age 65 but prior to completing his service requirement as having completed his service requirement. The costs associated with this plan are offset by earnings attributable to the Bank's purchase of Bank Owned Life Insurance (BOLI) on the lives of the participants. At December 31, 2006 and 2005, the Bank's liability under the SERP was \$49,925 and \$19,662, respectively, and expense for the years ended December 31, 2006 and 2005 was to \$29,870 and \$19,662, respectively. The increase in cash surrender value of the BOLI related to the participants was \$35,909 and \$32,340 for the years ended December 31, 2006 and 2005, respectively.

**Directors Deferral Plan:** The Bank established the Village Bank Outside Directors Deferral Plan (the Directors Deferral Plan) on January 1, 2005 under which non-employee Directors of Village Bank have the opportunity to defer receipt of all or a portion of certain compensation until retirement or departure from the Board of Directors. Deferral of compensation under the Directors Deferral Plan is voluntary by non-employee Directors and to participate in the plan a director must file a deferral election as provided in the plan. A Director shall become an active participant with respect to a plan year (as defined in the plan) only if he is expected to have compensation during the plan year and he timely files a deferral election. A separate account is established for each participant in the plan and each account shall, in addition to compensation deferred at the election of the participant, be credited with interest on the balance of the account, the rate of such interest to be established by the Board of Directors in its sole

discretion at the beginning of each plan year. The costs associated with this plan are partially offset by earnings attributable to the Bank's purchase of Bank Owned Life Insurance ( BOLI ) on the lives of the participants. At December 31, 2006 and 2005, the Bank's liability under the Directors Deferral Plan was \$106,361 and \$57,268, respectively, and expense for the years ended December 31, 2006 and 2005 was \$106,306 and \$57,268, respectively. The increase in cash surrender value of the BOLI related to the participants was \$16,553 and \$18,054 for the years ended December 31, 2006 and 2005, respectively.



**Note 16. Fair values of financial instruments**

The estimated fair values of the Company's financial instruments at December 31, 2006 and 2005 are as follows:

	2006 Carrying Value	Estimated Fair Value	2005 Carrying Value	Estimated Fair Value
<b>Financial assets</b>				
Cash and cash equivalents	\$ 17,198,503	\$ 17,198,503	\$ 25,828,554	\$ 25,828,554
Investment securities available for sale	12,787,644	12,787,644	2,981,903	2,981,903
Loans held for sale	3,149,178	3,149,178	2,860,440	2,860,440
Loans	238,498,418	239,615,657	170,447,273	167,454,882
Accrued interest receivable	2,301,264	2,301,264	936,589	936,589
<b>Financial liabilities</b>				
Deposits	253,309,881	252,984,711	186,752,807	186,519,135
FHLB borrowings	4,000,000	3,984,868	4,000,000	3,960,689
Trust preferred securities	5,155,000	5,155,000	5,155,000	5,155,000
Other borrowings	704,265	704,265	486,810	486,810
Accrued interest payable	429,986	429,986	221,324	221,324
<b>Off-balance-sheet instruments</b>				
Undisbursed credit lines		64,034,000		52,644,000
Commitments to extend or originate credit		30,072,000		28,371,000
Standby letters of credit		3,473,000		4,476,000

**Note 17. Parent corporation only financial statements****Balance Sheet****December 31, 2006 and 2005**

	2006	2005
<b>Assets</b>		
Cash and due from banks	\$ 62,918	\$ 915,758
Investment in subsidiaries	28,581,878	20,975,848
Investment in special purpose subsidiary	155,000	155,000
Prepaid expenses and other assets	2,670,880	385,438
	\$ 31,470,676	\$ 22,432,044
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Long-term debt - trust preferred securities	\$ 5,155,000	\$ 5,155,000
Payable to subsidiary	435,590	112,767
Other liabilities	235,971	12,384
Total liabilities	5,826,561	5,280,151
<b>Stockholders' equity</b>		
Preferred stock	-	-
Common stock	10,248,352	7,418,472
Additional paid-in capital	13,588,888	9,191,567
Accumulated other comprehensive income (loss)	(177,759)	(43,562)
Retained earnings	1,984,634	585,416
Total stockholders' equity	25,644,115	17,151,893
	\$ 31,470,676	\$ 22,432,044

**Statements of Income****Years Ended December 31, 2006, 2005 and 2004**

	2006	2005	2004
<b>Expenses</b>			
Interest	\$ 368,478	\$ 239,133	\$ -
Advertising and marketing	152	-	196
Supplies	44,400	56,352	22,200
Legal	64,741	6,186	24,388
Other outside services	-	8,726	4,992
Total expenses	477,771	310,397	51,776
Net loss before undistributed equity in subsidiary	(477,771)	(310,397)	(51,776)
Undistributed equity in subsidiary	1,717,220	1,456,088	574,010
Net income before income taxes	1,239,449	1,145,691	522,234
Income taxes (benefit)	(159,769)	(85,492)	(339,309)
	\$ 1,399,218	\$ 1,231,183	\$ 861,543

**Statement of Cash Flows****Years Ended December 31, 2006, 2005 and 2004**

	2006	2005	2004
<b>Cash Flows from Operating Activities</b>			
Net income	\$ 1,399,218	\$ 1,231,183	\$ 861,543
Adjustments to reconcile net income to net cash provided by operating activities			
Undistributed earnings of subsidiary	(1,717,220)	(1,456,088)	(913,319)
Increase in other assets	(2,285,442)	(447,898)	(92,539)
Increase in other liabilities	546,410	125,151	-
Net cash provided by operations	(2,057,034)	(547,652)	(144,315)
<b>Cash Flows from Investing Activities</b>			
Capital contribution to subsidiary	(6,000,000)	(5,000,000)	-
Net cash used in operations	(6,000,000)	(5,000,000)	-
<b>Cash Flows from Financing Activities</b>			
Proceeds from issuance of long-term debt	-	5,155,000	-

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Proceeds from issuance of common stock	7,204,194	947,315	505,410
Net cash provided by operations	7,204,194	6,102,315	505,410
Net increase in cash	(852,840)	554,663	361,095
Cash, beginning of period	915,758	361,095	-
Cash, end of period	\$ 62,918	\$ 915,758	\$ 361,095

**Note 18. Selected quarterly financial data (unaudited)**

Condensed quarterly financial data is shown as follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>2006</b>				
Interest income	\$ 3,942,375	\$ 4,395,821	\$ 5,213,505	\$ 5,467,410
Interest expense	1,720,851	1,879,155	2,479,324	2,707,270
Net interest				
income before provision for				
loan losses	2,221,524	2,516,666	2,734,181	2,760,140
Provision for				
loan losses	217,400	145,761	118,343	314,502
Gain on sale of				
loans	333,611	424,565	372,855	388,411
Fees and other				
noninterest income	243,941	210,478	230,225	278,707
Noninterest				
expenses	2,153,490	2,488,698	2,500,630	2,674,272
Income tax				
expense	145,583	175,865	244,218	137,324
Net income	282,603	341,385	474,070	301,160
Earnings per				
share				
Basic	\$ 0.15	\$ 0.16	\$ 0.19	\$ 0.12
Diluted	\$ 0.13	\$ 0.16	\$ 0.18	\$ 0.11
<b>2005</b>				
Interest income	\$ 2,451,364	\$ 2,691,710	\$ 3,005,921	\$ 3,776,138
Interest expense	921,812	1,095,443	1,301,160	1,558,961
Net interest				

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income before provision for				
loan losses	1,529,552	1,596,267	1,704,761	2,217,177
Provision for				
loan losses	90,533	37,071	155,374	177,883
Gain on sale of				
loans	282,725	541,281	621,773	521,075
Fees and other				
noninterest				
income	214,756	197,474	292,163	219,069
Noninterest				
expenses	1,528,888	1,789,762	2,070,643	2,388,711
Income tax				
expense	138,650	172,722	133,511	23,142
Net income	268,962	335,467	259,169	367,585
Earnings per				
share				
Basic	\$ 0.15	\$ 0.19	\$ 0.14	\$ 0.20
Diluted	\$ 0.14	\$ 0.17	\$ 0.13	\$ 0.18