Village Bank & Trust Financial Corp.
Form 10-Q
August 23, 2010

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

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

For the quarterly period ended June 30, 2010

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

For the transition period from ______ to ______

Commission file number: 0-50765

Virginia (State or other jurisdiction of incorporation or organization)	16-1694602 (I.R.S. Employer Identification No.)
15521 Midlothian Turnpike, Midlothian, Virginia Address of principal executive offices)	23113 (Zip code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes £ No £

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

Large Accelerated Filer £ Accelerated Filer £
Non-Accelerated Filer £ (Do not check if smaller reporting company) Smaller Reporting Company x

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

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

4,238,416 shares of common stock, $4.00 par value, outstanding as of August 20, 2010

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

ITEM 1 – FINANCIAL STATEMENTS

Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Balance Sheets
June 30, 2010 (Unaudited) and December 31, 2009

	June 30, 2010	December 31, 2009 *
Assets		
Cash and due from banks	$ 31,335,272	$ 13,884,581
Federal funds sold	12,037,402	6,777,239
Investment securities available for sale	24,199,460	54,857,211
Loans held for sale	23,473,948	7,506,252
Loans		
Outstandings	463,499,004	467,359,664
Allowance for loan losses	(9,499,964)	(10,521,931)
Deferred costs	474,467	208,883
	454,473,507	457,046,616
Premises and equipment, net	27,630,756	27,799,084
Accrued interest receivable	2,610,181	3,366,718
Bank owned life insurance	5,772,771	5,431,002
Other real estate owned	11,815,767	11,278,532
Other assets	13,149,467	14,046,120
	$ 606,498,531	$ 601,993,355
Liabilities and Stockholders' Equity		
Liabilities		
Deposits	$ 503,536,765	$ 498,285,124
Trust preferred securities	8,764,000	8,764,000
Federal home loan bank advances	28,750,000	29,000,000
Other borrowings	13,935,488	14,829,521
Accrued interest payable	450,540	501,069
Other liabilities	2,463,838	2,765,550
Total liabilities	557,900,631	554,145,264
Stockholders' equity		
Preferred stock, $4 par value, $1,000 liquidation preference, 1,000,000 shares authorized, 14,738 shares issued and outstanding	58,952	58,952
Common stock, $4 par value - 10,000,000 shares authorized; 4,238,416 shares issued and outstanding at June 30, 2010 and 4,230,628 at December 31, 2009	16,953,664	16,922,512
Additional paid-in capital	40,587,801	40,568,771
Retained earnings deficit	(9,231,328)	(9,741,459)

Warrant Surplus	732,479	732,479
Discount on preferred stock	(564,891)	(636,959)
Accumulated other comprehensive income (loss)	61,223	(56,205)
Total stockholders' equity	48,597,900	47,848,091
	$ 606,498,531	$ 601,993,355

* Certain December 31, 2009 amounts have been revised. See Note 2 to the condensed consolidated financial statements

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Income
For the Three and Six Months Ended June 30, 2010 and 2009

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Interest income				
Loans	$ 7,214,558	$ 8,136,161	$ 14,303,802	$ 16,145,858
Investment securities	285,797	286,519	642,917	622,977
Federal funds sold	16,004	5,136	30,236	12,409
Total interest income	7,516,359	8,427,816	14,976,955	16,781,244
Interest expense				
Deposits	2,278,519	3,824,352	4,789,486	7,827,808
Borrowed funds	536,244	435,569	1,070,064	878,874
Total interest expense	2,814,763	4,259,921	5,859,550	8,706,682
Net interest income	4,701,596	4,167,895	9,117,405	8,074,562
Provision for loan losses	1,240,000	3,100,000	1,740,000	4,200,000
Net interest income after provision for loan losses	3,461,596	1,067,895	7,377,405	3,874,562
Noninterest income				
Service charges and fees	515,293	452,636	890,573	825,755
Gain on sale of loans	1,633,861	1,509,971	2,838,224	2,453,087
Gain (loss) on sale of assets	489,162	(38,234)	840,941	(37,873)
Rental income	109,831	40,349	213,502	82,019
Other	238,578	71,022	358,085	169,141
Total noninterest income	2,986,725	2,035,744	5,141,325	3,492,129
Noninterest expense				
Salaries and benefits	2,987,115	2,558,276	5,754,504	5,022,890
Occupancy	472,227	417,457	982,145	861,500
Equipment	220,760	202,305	439,114	457,924
Supplies	116,824	124,773	251,186	250,598
Professional and outside services	493,810	456,108	1,016,619	891,749
Advertising and marketing	136,034	86,675	225,660	158,170
Other real estate owned expenses	471,508	905,592	681,336	945,515
Other operating expense	853,406	1,052,343	1,732,379	1,592,081
Total noninterest expense	5,751,684	5,803,529	11,082,943	10,180,427
Net income (loss) before income taxes	696,637	(2,699,890)	1,435,787	(2,813,736)
Income tax expense (benefit)	236,856	(917,962)	488,167	(956,671)
Net income (loss)	459,781	(1,781,928)	947,620	(1,857,065)

Preferred stock dividends and amortization of discount		219,754		123,153		437,489		123,153
Net income (loss) available to common shareholders	$	240,027	$	(1,905,081)	$	$ 510,131	$	(1,980,218)
Earnings (loss) per share, basic	$	0.06	$	(0.45)	$	0.12	$	(0.47)
Earnings (loss) per share, diluted	$	0.06	$	(0.45)	$	0.12	$	(0.47)

See accompanying notes to consolidated financial statements

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Stockholders' Equity
For the Six Months Ended June 30, 2010 and 2009

	Prefered Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Warrant	Discount on Preferred Stock	Accumulated Other Comprehensive Income (loss)	Total
Balance, December 31, 2009 *	$ 58,952$	16,922,512$	40,568,771$	(9,741,459)$	732,479$	(636,959)$	(56,205)$	47,848,09
Amortization of preferred stock discount	-	-	-	(72,068)	-	72,068	-	-
Preferred stock dividend	-	-	-	(365,421)	-	-	-	(365,421
Issuance of common stock	-	31,152	(31,152)	-	-	-	-	-
Stock based compensation	-	-	50,182	-	-	-	-	50,18
Net income	-	-	-	947,620	-	-	-	947,62
Minimum pension adjustment (net of income taxes of 2,210)	-	-	-	-	-	-	4,290	4,29
Change in unrealized gain (loss) on securities available for sale (net of income taxes of $58,283)	-	-	-	-	-	-	113,138	113,13
Total comprehensive income (loss)	-	-	-	-	-	-	-	1,065,04
Balance, June 30, 2010	$ 58,952$	16,953,664$	40,587,801$	(9,231,328)$	732,479$	(564,891)$	61,223$	48,597,90
Balance, December 31, 2008	$ - $	16,917,488$	25,737,048$	3,453,788$	- $	- $	54,250$	46,162,57

Issuance of preferred stock	58,952		14,679,048	-	732,479	(732,479)		14,738,00
Amortization of preferred stock discount	-	-	-	(23,818)	-	23,818	-	-
Preferred stock dividend	-	-	-	(123,153)	-	-	-	(123,153
Issuance of common stock	-	5,024	(5,024)	-	-	-	-	-
Stock based compensation	-	-	87,260	-	-	-	-	87,26
Net income (loss)	-	-	-	(1,857,066)	-	-	-	(1,857,066
Minimum pension adjustment (net of income taxes of $1,459)	-	-	-	-			4,290	4,29
Change in unrealized gain (loss) on securities available for sale (net of income taxes of $54,089)	-	-	-	-	-	-	(130,186)	(130,186
Total comprehensive income (loss)	-	-	-	-	-	-	-	(1,982,962
Balance, June 30, 2009	$ 58,952	$ 16,922,512	$ 40,498,332	$ 1,449,751	$ 732,479	$ (708,661)	$ (71,646)	$ 58,881,71

* Certain December 31, 2009 amounts have been revised. See Note 2 to the condensed consolidated financial statements

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Cash Flows
Six Months Ended June 30, 2010 and 2009

	2010	2009
Cash Flows from Operating Activities		
Net income (loss)	$ 947,620	$ (1,857,066)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	641,674	619,533
Provision for loan losses	1,740,000	4,200,000
Write-down of other real estate owned	93,000	-
Gain on securities	(597,375)	(8,061)
Gain on loans sold	(2,838,224)	(2,453,087)
Gain on sale of premises and equipment	(242,936)	(37,872)
Gain on sale of other real estate owned	(40,384)	-
Stock compensation expense	50,182	87,260
Proceeds from sale of mortgage loans	115,654,593	114,618,514
Origination of mortgage loans for sale	(128,785,065)	(127,359,964)
Amortization of premiums and accrection of discounts on securities, net	290,210	24,444
Decrease in interest receivable	756,537	343,678
Increase in bank owned life insurance	(341,769)	(41,759)
(Increase) decrease in other assets	842,660	(1,792,852)
Decrease in interest payable	(50,529)	(191,957)
Decrease in other liabilities	(301,712)	(257,514)
Net cash used in operating activities	(12,181,518)	(14,106,703)
Cash Flows from Investing Activities		
Purchases of available for sale securities	(6,859,145)	(6,230,297)
Maturities and calls of available for sale securities	36,670,662	9,395,167
Proceeds from the sale and calls of available for sale securities	1,324,821	500,775
Proceeds from sale of other real estate owned	2,212,801	-
Net increase in loans	(1,968,543)	(10,072,343)
Purchases of premises and equipment	(607,731)	(574,454)
Proceeds from sale of premises and equipment	377,321	406,516
Net cash provided by (used in) investing activities	31,150,185	(6,574,636)
Cash Flows from Financing Activities		
Issuance of preferred stock	-	14,738,000
Net increase in deposits	5,251,641	17,431,308
Net decrease in federal home loan bank advances	(250,000)	
Net decrease in other borrowings	(894,033)	(7,529,907)
Dividends on preferred stock	(365,421)	(123,153)
Net cash provided by financing activities	3,742,187	24,516,248
Net increase in cash and cash equivalents	22,710,854	3,834,909
Cash and cash equivalents, beginning of period	20,661,820	26,600,829

Cash and cash equivalents, end of period	$	43,372,674	$	30,435,738
Supplemental Schedule of Non Cash Activities				
Real estate owned assets acquired in settlement of loans	$	2,801,652	$	3,743,473

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements (Unaudited)

Note 1 - Principles of presentation

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

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

In the opinion of management, the accompanying condensed consolidated financial statements of the Company have been prepared on the accrual basis in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, all adjustments that are, in the opinion of management, necessary for a fair presentation have been included. The results of operations for the three and six month periods ended June 30, 2010 are not necessarily indicative of the results to be expected for the full year ending December 31, 2010. The unaudited interim financial statements should be read in conjunction with the audited financial statements and notes to financial statements that are presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the Securities and Exchange Commission.

Note 2 – Correction of an immaterial error

During the second quarter of 2010, the Company identified an error related to the calculation of its income tax benefit for the fourth quarter of the year ended December 31, 2009. The Company evaluated the error in accordance with Accounting Standards Codification 250-10-45-27 Materiality Determination for Correction of an Error and Staff Accounting Bulletin No. 99, Materiality. Although the error was considered to be immaterial to the fourth quarter and year ended December 31, 2009, because of the significance of the out-of-period error to the second quarter of 2010, the Company applied the guidance of SAB No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements, and revised its 2009 financial statements for the immaterial error.

The following is a reconciliation of the effects of the adjustments made to the Company’s previously reported December 31, 2009 consolidated balance sheet to the revised consolidated balance sheet appearing in the Form 10-Q:

	December 31, 2009		
	As Reported	Adjustment	As Revised
Other assets	$ 15,015,708	$ (969,588)	$ 14,046,120
Other liabilities	2,641,410	124,140	2,765,550
Retained earnings deficit	(8,647,731)	(1,093,728)	(9,741,459)

The effect of the correction on retained earnings was a result of decreasing the income tax benefit for 2009 by approximately $1,094,000 which increased the net loss by the same amount, representing an increase in the loss per basic and diluted share of $0.26.

The effect of the adjustments on the Company's capital ratios was immaterial and did not change the "well capitalized" classification of the Company or the Bank.

Note 3 - Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheets and statements of income for the period. Actual results could differ significantly from those estimates.

Note 4 - Earnings per common share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Numerator				
Net income (loss) - basic and diluted	$ 459,781	$ (1,781,928)	$ 947,620	$ (1,857,065)
Preferred stock dividend and amortization of discount	219,754	123,153	437,489	123,153
Net income (loss) available to common shareholders	$ 240,027	$ (1,905,081)	$ 510,131	$ (1,980,218)
Denominator				
Weighted average shares outstanding - basic	4,238,370	4,230,603	4,237,042	4,230,293
Dilutive effect of common stock options and restricted stock awards	-	-	-	-
Weighted average shares outstanding - diluted	4,238,370	4,230,603	4,237,042	4,230,293

Earnings (loss) per share - basic and diluted				
Earnings (loss) per share - basic	$ 0.06	$ (0.45)	$ 0.12	$ (0.47)
Effect of dilutive common stock options	-	-	-	-
Earnings (loss) per share - diluted	$ 0.06	$ (0.45)	$ 0.12	$ (0.47)

Outstanding options and warrants to purchase common stock were considered in the computation of diluted earnings per share for the periods presented. Stock options and warrants for 310,205 and 499,029 shares, respectively, of common stock were not included in computing diluted earnings per share for the three and six month ended June 30, 2010 because their effects were anti-dilutive. Options and warrants to acquire 333,955 and 499,029 shares, respectively, of common stock were anti-dilutive for the three and six month period ended June 30, 2009.

Note 5 – Investment securities available for sale

At June 30, 2010 and December 31, 2009, 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
June 30, 2010					
US Government Agencies					
Within one year	$ 6,000	$ $6,035	$ 33	$ 6,068	2.13%
One to five years	6,463	6,735	98	6,833	1.78%
Five to ten years	-	-	-	-	-
More than ten years	-	-	-	-	-
Total	12,463	12,770	131	12,901	1.95%
Mortgage-backed securities					
Within one year	1,361	1,402	51	1,453	2.18%
One to five years	1,720	1,779	50	1,829	2.78%
Five to ten years	3,883	3,887	(18)	3,869	2.71%
More than ten years	16	17	(1)	16	3.04%
Total	6,980	7,085	82	7,167	2.62%
Municipals					
Five to ten years	2,000	2,103	41	2,144	5.19%
Other investments					
More than five years	2,000	1,974	13	1,987	5.65%
Total investment securities	$ 23,443	$ 23,932	$ 267	$ 24,199	2.74%
December 31, 2009					
US Government Agencies					
One to five years	$ 9,000	$ 9,315	$ (66)	$ 9,249	2.32%
Five to ten years	3,000	3,029	32	3,061	4.50%
More than ten years	34,250	35,284	75	35,359	5.73%
Total	46,250	47,628	41	47,669	5.70%
Mortgage-backed securities					
One to five years	389	435	(37)	$ 398	4.40%
Five to ten years	471	471	29	500	5.24%
More than ten years	3,141	3,227	53	3,280	5.42%
	4,001	4,133	45	4,178	5.39%
Municipals					
More than ten years	1,000	1,026	1	1,027	5.28%

Other investments					
More than five years	2,000	1,973	10	1,983	5.65%
Total investment securities	$ 53,251	$ 54,760	$ 97	$ 54,857	4.72%

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Investment securities available for sale that have an unrealized loss position at June 30, 2010 and December 31, 2009 are detailed below.

	Securities in a Loss Position for Less Than 12 Months		Securities in a Loss Position for More Than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(in thousands)			
June 30, 2010						
Investment securities available for sale						
US Government Agencies	$ 1,459	$ (4)	$ -	$ -	$ 1,459	$ (4)
Mortgage-backed securities	4,404	(43)	-	-	4,404	(43)
Total	$ 5,863	$ (47)	$ -	$ -	$ 5,863	$ (47)
December 31, 2009						
Investment securities available for sale						
US Government Agencies	$ 19,542	$ (264)	$ -	-	$ 19,542	$ (264)
Total	$ 19,542	$ (264)	-	$ -	$ 19,542	$ (264)

Management does not believe that any individual unrealized loss as of June 30, 2010 and December 31, 2009 is other than a temporary impairment. These unrealized losses are primarily attributable to changes in interest rates. The Company has the ability to hold these securities for a time necessary to recover the amortized cost or until maturity when full repayment would be received.

Note 6 – Deposits

Deposits as of June 30, 2010 and December 31, 2009 were as follows:

	June 30, 2010		December 31, 2009	
	Amount	%	Amount	%
Noninterest bearing demand	$ 44,150,453	8.77%	$ 38,520,878	7.73%
Now	35,242,967	7.00%	36,441,259	7.31%
Money market	102,389,471	20.33%	115,166,477	23.11%
Savings	10,320,106	2.05%	8,901,299	1.79%
	125,134,684	24.85%	119,352,471	23.95%

Time deposits of $100,000 and over						
Other time deposits		186,299,084	37.00%		179,902,740	36.11%
Total	$	503,536,765	100.00%	$	498,285,124	100.00%

Note 7 – Trust preferred securities

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, $5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at June 30, 2010 was 2.20%. The securities were redeemable at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. No amounts have been redeemed at June 30, 2010 and there are no plans to do so. The principal asset of the Trust is $5.2 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

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

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

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

Note 8 – Stock incentive plan

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

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

	Six Months Ended June 30,							
	2010				2009			
	Options	Weighted Average Exercise Price	Fair Value Per Share	Intrinsic Value	Options	Weighted Average Exercise Price	Fair Value Per Share	Intrinsic Value
Options outstanding, beginning of period	336,005	$ 9.58	$ 4.75		333,955	$ 9.63	$ 4.77	
Granted	-	-	-		-	-	-	
Forfeited	(25,800)	10.77	5.02		-	-	-	
Exercised	-	-	-		-	-	-	
Options outstanding, end of period	310,205	$ 9.48	$ 4.73	$ -	333,955	$ 9.63	$ 4.77	$ -
Options exercisable, end of period	291,350				298,600			

During the first quarter of 2009, we granted to certain officers 26,592 restricted shares of common stock with a weighted average fair market value of $4.60 at the date of grant. These restricted stock awards have three-year graded vesting. Prior to vesting, these shares are subject to forfeiture to us without consideration upon termination of employment under certain circumstances. The total number of shares underlying non-vested restricted stock and performance share awards was 14,881 and 33,998 at June 30, 2010 and 2009, respectively.

Stock-based compensation expense was $50,182 and $87,260 for the six months ended June 30, 2010 and 2009, respectively. Unamortized stock-based compensation related to nonvested share based compensation arrangements granted under the Incentive Plan as of June 30, 2010 and 2009 was $170,568 and $399,665, respectively. The time based unamortized compensation of $170,568 is expected to be recognized over a weighted average period of 1.56 years.

Note 9 — Fair value

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

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transaction involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are independent, knowledgeable, able to transact and willing to transact.

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

Level 1 Inputs — Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 Inputs — Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 Inputs- Significant unobservable inputs that reflect a company’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

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

Investment securities: The fair values for investment securities are determined by quoted prices for similar assets or liabilities (Level 2).

Impaired loans: The fair values of impaired loans are measured for impairment using the fair value of the collateral for collateral-dependent loans on a nonrecurring basis. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The use of appraisals, discounted cash flow models and management's best judgment are significant inputs in arriving at the fair value measure of the underlying collateral and are therefore classified within (Level 3).

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

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

	Fair Value Measurement at June 30, 2010 Using			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Financial Assets-Recurring				
US Government Agencies	$ 12,901	$ -	$ 12,901	$ -
MBS	7,167	-	7,167	-
Municipals	2,144	-	2,144	-
Other available for sale (1)	1,987	-	1,987	-
Financial Assets-Non-Recurring				
Impaired loans	$ 31,106	$ -	$ -	$ 31,106
Real estate owned	11,816	-	-	11,816
Residential loans held for sale	23,474	-	23,474	-

(1) Excludes restricted stock.

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	Fair Value Measurement at December 31, 2009 Using			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Financial Assets-Recurring				
US Government Agencies	$ 47,669	$ -	$ 47,669	$ -
MBS	4,178	-	4,178	-
Municipals	1,027	-	1,027	-
Other available for sale (1)	1,983	-	1,983	-
Financial Assets-Non-Recurring				
Impaired loans	$ 25,913	$ -	$ -	$ 25,913
Real estate owned	11,279	-	-	11,279
Residential loans held for sale	7,506	-	7,506	-

(1) Excludes restricted stock.

In general, fair value of securities is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon market prices determined by an outside, independent entity that primarily uses as inputs, observable market-based parameters. Fair value of loans held for sale is based upon internally developed models that primarily use as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

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

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

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

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

Borrowings – The fair value of 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.

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

Off-balance-sheet instruments –The fair value of commitments to extend credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of commitments to extend credit, including letters of credit, is estimated to approximate their aggregate book balance.

	June 30, 2010		December 31, 2009	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial assets				
Cash and cash equivalents	$ 43,372,674	$ 43,372,674	$ 20,661,820	$ 20,661,820
Investment securities available for sale	24,199,460	24,199,460	54,857,211	54,857,211
Loans held for sale	23,473,948	23,473,948	7,506,252	7,506,252
Loans	454,473,507	453,698,255	457,046,616	466,271,730
Accrued interest receivable	2,610,181	2,610,181	3,366,718	3,366,718
Financial liabilities				
Deposits	503,536,765	513,901,281	498,285,124	500,979,984
FHLB borrowings	28,750,000	28,537,963	29,000,000	29,011,904
Trust preferred securities	8,764,000	8,724,602	8,764,000	8,764,000
Other borrowings	13,935,488	13,903,001	14,829,521	14,783,055
Accrued interest payable	450,540	450,540	501,069	501,069
Off-balance-sheet instruments				
Undisbursed credit lines		52,973,258		49,621,000
Commitments to extend or originate credit		19,908,750		19,078,000
Standby letters of credit		3,500,194		4,177,000

Note 10 – Capital Purchase Program

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

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

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

Note 11 – Recent accounting pronouncements

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

In March 2010, the FASB issued ASU No. 2010-09 amending FASB ASC Topic 855 to exclude SEC reporting entities from the requirement to disclose the date on which subsequent events have been evaluated. It further modifies the requirement to disclose the date on which subsequent events have been evaluated in reissued financial statements to apply only to such statements that have been restated to correct an error or to apply U.S. GAAP retrospectively. The Company has complied with ASU No. 2010-09.

New authoritative accounting guidance under ASC Topic 860, "Transfers and Servicing," amended prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new authoritative accounting guidance eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative accounting guidance under ASC Topic 860 became effective January 1, 2010 and did not have a significant impact on the Company's consolidated financial statements.

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

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Caution about forward-looking statements

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

There are many factors that could have a material adverse effect on the operations and future prospects of the Company including, but not limited to, changes in interest rates, general economic conditions, the quality or composition of the loan or investment portfolios, the level of nonperforming assets and charge-offs, the local real estate market, volatility and disruption in national and international financial markets, government intervention in the U.S. financial system, changes in regulations applicable to the Company, demand for loan products, deposit flows, competition, accounting principles, policies and guidelines, and any other risks discussed in this report or in "Item 1A Risk Factors" in the Annual Report on Form 10-K for the year ended December 31, 2009. Monetary and fiscal policies of the U.S. Government could also adversely effect the Company; such policies include the impact of any regulations or programs implemented pursuant to the Emergency Economic Stabilization Act of 2008 (EESA), the American Recovery and Reinvestment Act of 2009 (ARRA), the Dodd-Frank Wall Street Reform and Consumer Protection Act and other policies of the Office of the Comptroller of the Currency, U.S. Treasury and the Federal Reserve Board.

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

General

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

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

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The Company's primary source of earnings is net interest income, and its principal market risk exposure is interest rate risk. The Company is not able to predict market interest rate fluctuations and its asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on the Company's results of operations and financial condition. In addition, revenues are generated from fees charged on deposit accounts and gains from sale of mortgage loans to third-party investors.

Although management endeavors to minimize the credit risk inherent in the Company's loan portfolio, it must necessarily make various assumptions and judgments about the collectability of the loan portfolio based on its experience and evaluation of economic conditions. If such assumptions or judgments prove to be incorrect, the current allowance for loan losses may not be sufficient to cover loan losses and additions to the allowance may be necessary, which would have a negative impact on net income.

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

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

For the three months ended June 30, 2010, the Company had net income totaling $460,000 and net income available to common shareholders of $240,000, or $0.06 per fully diluted share, compared to a net loss of $(1,782,000) and a net loss available to common shareholders of $(1,905,000), or $(.45) per fully diluted basis, for the same period in 2009. The most significant factors in our improving earnings were a decline in the provision for loan losses of $1,860,000, from $3,100,000 in 2009 to $1,240,000 in 2010, a decline in our cost of deposits greater than a decline in the yield on loans resulting in an increase in net interest income of $534,000, and a gain from sale of securities of $489,000 in 2010.

Our total assets increased to $606,498,000 at June 30, 2010 from $601,993,000 at December 31, 2009, an increase of $4,505,000, or 1%. Liquid assets (cash and due from banks, federal funds sold and investment securities available for sale) decreased by $(7,947,000), loans held for sale increased by $15,968,000, net portfolio loans decreased by $(2,573,000), accrued interest receivable decreased by $(756,000), and other real estate owned increased by $537,000. The net increase in assets of $4,505,000 was funded by an increase in deposits of $5,252,000 offset by a decrease in borrowings of $1,144,000.

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The following presents management's discussion and analysis of the financial condition of the Company at June 30, 2010 and December 31, 2009, and results of operations for the Company for the three and six month periods ended June 30, 2010 and 2009. This discussion should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the Securities and Exchange Commission as well as the second quarter 2010 financial statements and notes thereto appearing elsewhere in this report.

Results of operations

For the three months ended June 30, 2010, the Company had net income of $460,000 and net income available to common shareholders of $240,000, or $0.06 per fully diluted share, compared to a net loss of $(1,782,000) and a net loss available to common shareholders of $(1,905,000) or $(.45) per fully diluted share, for the same period in 2009. For the six months ended June 30, 2010, the Company had net income totaling $948,000 and net income available to common shareholders of $510,000, or $0.12 per share on a fully diluted basis, compared to a loss totaling $(1,857,000), and a net loss available to common shareholders of $(1,980,000), or $(.47) per share on a fully diluted basis for the same period in 2009. This represents increases in profitability (net income (loss) before payment of dividends) of $2,242,000, or 126%, and $2,805,000, or 151%, for the three and six month periods, respectively.

The increase in net earnings during the three and six months ended June 30, 2010 compared to the same periods in 2009 is primarily a result of:

	Second Quarter 2010 Compared to Second Quarter 2009	Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009
Increase in net interest income	$ 534,000	$ 1,043,000
Decrease in provision for loan losses	1,860,000	2,460,000
Increase in gain on sale of loans	124,000	385,000
Gain on sale of securities	489,000	489,000
Gain on sale of land	-	243,000
Decrease (increase) in noninterest expenses	52,000	(903,000)

The increase in net interest income is primarily attributable to the significant decline in the cost of deposits. Our cost of deposits declined from 3.58% for the first six months of 2009 to 2.07% for the first six months of 2010. The decrease in the provision for loan losses is due to a slowing of the deterioration of asset quality and is discussed in more detail under Asset Quality and Provision for Loan Losses. The increase in gain on sale of loans is attributable to increased loan production by the mortgage banking subsidiary of the Bank. The mortgage subsidiary closed $128,785,000 in mortgage loans for the first six months of 2010 compared to $127,360,000 in 2009. And the increase in noninterest expenses is primarily attributable to increases in salaries and benefits of $732,000 and occupancy costs of $121,000 resulting from the addition of the mortgage company's loan production office in Northern Virginia as well as the startup of a financial services division of the Bank. The quarter to quarter comparison does not reflect a similar increase because the increases in salaries and benefits and occupancy costs were offset by a similar decline in expenses related to foreclosed real estate during the second quarter of 2010.

Net interest income

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

Net interest income for the second quarter of $4,702,000 represents an increase of $534,000, or 13%, compared to the second quarter of 2009, and an increase of $286,000, or 6%, compared to the first quarter of 2010. Theses increases are a result of a decline in the Company's cost of funds that was greater than a decline in the yield on earning assets. Our cost of funds declined from 3.50% for the second quarter of 2009 to 2.36% for the first quarter of 2010 and to 2.19% for the second quarter of 2010, a decline of 1.31% from the second quarter of 2009 to the second quarter of 2010. The yield on earning assets declined from 6.41% for the second quarter of 2009 to 5.54% for the second quarter of 2010, a decline of .87%.

The Company's net interest margin is not a measurement under accounting principles generally accepted in the United States, but is a common measure used by the financial services industry to determine how profitably earning assets are funded. Net interest margin is calculated by dividing net interest income by average earning assets. Net interest margin may be affected by interest on nonaccrual loans as any accrued but unpaid interest is deducted from interest income when a loan is placed on nonaccrual status. Conversely, if a nonaccrual loan is returned to performing status, the accrued but unpaid interest is added back to interest income. As our nonaccrual loans have increased, the effect on nonaccrual interest has been more significant (see discussion of nonaccrual loans under Asset Quality and Provision for Loan Losses). Management believes presenting our actual net interest margin and our net interest margin adjusted for nonaccrual interest for the indicated periods is meaningful to the reader in understanding operating performance. Our net interest margin over the last several quarters is provided in the following table:

Quarter Ended	Actual	Adjusted for Interest On Non-Accrual Loans
June 30, 2009	3.17%	3.27%
September 30, 2009	3.17%	3.32%
December 31, 2009	3.22%	3.27%
March 31, 2010	3.26%	3.52%
June 30, 2010	3.46%	3.52%

As interest rates were reduced by the Federal Reserve during 2007 and 2008 in reaction to the declining economy, our margin was compressed as our deposits generally do not reprice as quickly as our loans. Because our deposits continue to reprice downward and the yield on interest earning assets appears to be stabilizing, we expect the upward trend in our net interest margin to continue. However, given the continued depressed economy and the potential impact on interest income from new nonaccrual loans, no assurance can be provided that this will occur.

Average interest-earning assets for the first six months of 2010 increased by $23,643,000, or 5%, compared to the first six months of 2009. The increase in interest-earning assets was due primarily to an increase in investment securities of $19,323,000 and federal funds sold of $12,272,000, offset by a decline in loans of $9,123,000. The average yield on interest-earning assets decreased to 5.51% for the first six months of 2010 compared to 6.45% for the same period in 2009. Many of our loans are indexed to short-term rates affected by the Federal Reserve's decisions about short-term interest rates, and, accordingly, as the Federal Reserve increases or decreases short-term rates, the yield on interest-earning assets is affected. As the Federal Reserve decreased interest rates starting in 2007 and into 2008, decreasing short-term interest rates by 5% over twelve months, the average yield on our interest-earning assets decreased. Additionally, while many of our indexed rate loans have interest rate floors included in their terms, we have decreased rates to loan customers to better reflect the current interest rate environment and, in some limited cases, to facilitate workouts on nonperforming loans.

Our average interest-bearing liabilities increased by $27,015,000, or 5%, for the first six months of 2010 compared to the first six months of 2009. The increase in interest-bearing liabilities was primarily due to growth in average deposits of $24,720,000. The average cost of interest-bearing liabilities decreased to 2.28% for the first six months of 2010 from 3.57% for the first six months of 2009. The principal reason for the decrease in liability costs was the reduction in short-term interest rates by the Federal Reserve and our efforts to reduce rates for repricing liabilities. See our discussion of interest rate sensitivity below for more information.

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

Average Balance Sheets
(in thousands)

	Three Months Ended June 30, 2010			Three Months Ended June 30, 2009		
	Average Balance	Interest Income/ Expense	Annualized Yield Rate	Average Balance	Interest Income/ Expense	Annualized Yield Rate
Loans net of deferred fees	$ 464,233	$ 7,034	6.08%	$ 477,692	$ 7,977	6.70%
Investment securities	38,833	286	2.95%	23,231	286	4.94%
Loans held for sale	14,412	180	5.01%	13,112	160	4.89%
Federal funds and other	27,142	16	0.24%	13,528	5	0.15%
Total interest earning assets	544,620	7,516	5.54%	527,563	8,428	6.41%
Allowance for loan losses and deferred fees						