

## ***Dear Shareholder:***

***Well ...***, if you had asked five years ago if someone would take any pride in saying they were a banker, the answer would have been most predominantly “Yes.” Today, thanks to a somewhat generalizing style of journalism, we bankers are a bit of a shy bunch. However, here at Colonial Virginia Bank (the “Bank”), we still practice “good ole banking principles.” We know our customers; we fairly price customer transactions, and most of all, we CARE about our customer relationships! It’s not always easy in a tumultuous economic environment, with volatile interest rates and unpredictable changes in employment / unemployment, to accurately predict loan demand and overall asset quality and the attendant funding strategies (deposits, etc.) to support loan and investment operations. We have been consistent, though, in evaluating our growth plans with a balance sheet management philosophy that pays attention to quality of assets, pricing of products, and expansion / retention of our most desired customer relationships.

Growth for 2008 was steady and manageable. Total assets were \$110.8 million at December 31, 2008 compared to \$95.5 million at December 31, 2007, a 16.0% increase. Net loans increased 15.6% from \$53.7 million at year-end 2007 to \$62.1 million December 31, 2008. Year-end 2008 deposits totaled \$86.8 million compared to \$82.9 million at year-end 2007, a 4.7% increase. The Bank continues to enjoy a healthy balance sheet with non-performing assets at December 31, 2008, representing a minimal 0.05% of total assets, down from 0.07% at December 31, 2007. The Bank has cautiously targeted growth that not only attempts to maximize net interest margins, but also protects overall asset quality.

The Bank has not been a participant in the much maligned “sub-prime” lending practices that have plagued much of the commercial and mortgage banking industries. Additionally, it is important to note that the Bank held no Federal National Mortgage Association (“FNMA”) or Federal Home Loan Mortgage Corporation (“FHLMC”) preferred stock in its investment portfolio, thus, the Bank experienced no asset value write-downs of these troubled entities. While there was much publicity of the “bailout” of the financial services industry and the Troubled Asset Relief Program (“TARP”), the Bank elected not to apply for or participate in this program. The Board of Directors and management determined that more traditional means of capital generation (i.e. issuance of common stock) were more appropriate for the long-term strategic plans of the Bank. The Bank is also more than adequately capitalized for both the current balance sheet, as well as growth for the foreseeable future.

Net income of \$134,938 or \$0.22 per share, assuming dilution, for year ended December 31, 2008, compared with \$97,307 or \$0.16 per share, assuming dilution, for the same period of 2007, increases of 38.7% and 37.5%, respectively. The Bank relies primarily on net interest income (interest income on loans and investments minus interest expense on deposits) for its overall net income. Net interest income for the year-ended 2008 was \$3,264,069 compared to \$3,088,348 for the same period in 2007, a 5.7% increase. Despite the overall lower interest rate environment, deposit customers continue to seek / demand a minimal threshold for CD rates, thus, keeping pressure on funding costs and the resultant net interest margin. As the economy continues in a precarious state, 2009 will likely be another challenging year.

As announced previously, we will be expanding our branch structure by opening our third office in the Maidstone Village project in New Kent County Court House. The project is a planned unit development that will include commercial and residential units. The project, through no fault of the Bank, experienced some unexpected delays in the overall implementation of the development (water, sewer, other utilities, weather, etc.). Therefore, what was planned as a third quarter 2008 opening is now

projected to be an April 2009 event. The new branch office is located in the middle of the county's activity hub, courthouse, schools, and government offices and is expected to be a hotspot of the county's future. There will be a full time child day care center, as well as a dental practice adjacent to our banking office.

Your Board and Management team are committed to the highest standards of integrity in financial reporting and the execution of our corporate mission as a community partner within all the markets we serve. We continue to thank you for your loyal support and pledge to stay the course in creating shareholder value.

Sincerely,

W.J. Farinholt  
President & CEO

Joseph A. Lombard, Jr. DDS  
Chairman of the Board

## SELECTED FINANCIAL DATA

At and for the Years Ended December 31, 2008, 2007, 2006, 2005 and 2004

	2008	2007	2006	2005	2004
<b>EARNINGS STATEMENT DATA:</b>					
Interest income	\$6,431,125	\$6,219,877	\$4,932,046	\$3,111,119	\$1,471,497
Interest expense	3,167,056	3,131,529	2,069,645	920,146	345,374
Net interest income	3,264,069	3,088,348	2,862,401	2,190,973	1,126,123
Provision for loan losses	239,200	190,700	29,200	22,850	270,590
Noninterest income	491,353	264,196	209,110	116,512	78,392
Noninterest expense	3,294,610	3,287,852	2,679,725	2,130,090	1,862,223
Income before income taxes	221,612	(126,008)	362,586	154,545	(928,298)
Income tax (benefit)	86,674	(223,315)	(206,008)	--	--
Net Income	\$134,938	\$97,307	\$568,594	\$154,545	(\$928,298)
<b>PER SHARE DATA:</b>					
Net income, basic	\$0.22	\$0.16	\$0.94	\$0.26	(\$1.53)
Net income, diluted	0.22	0.16	0.93	0.25	(1.53)
Weighted average shares outstanding, basic	610,175	609,011	606,648	605,175	605,175
Weighted average shares outstanding, diluted	610,743	615,150	613,910	607,525	605,807
Book value at period end	\$19.51	\$18.86	\$18.15	\$17.46	\$17.36
<b>BALANCE SHEET DATA:</b>					
Total Assets	\$110,771,902	\$95,460,101	\$81,187,526	\$60,997,185	\$43,590,593
Loans, net	62,120,125	53,658,504	46,125,422	39,375,508	29,399,114
Investment securities	27,137,531	29,737,313	21,243,817	8,235,924	5,450,360
Deposits	86,788,963	82,948,700	69,410,928	50,159,293	32,944,218
Stockholders' equity	\$11,901,771	\$11,505,953	\$11,026,737	\$10,568,194	\$10,504,111
<b>PERFORMANCE RATIOS:</b>					
Net interest margin (1)	3.43%	3.81%	4.42%	4.83%	3.96%
Return on average assets	0.13%	0.11%	0.79%	0.29%	-2.88%
Return on average equity	1.17%	0.86%	5.28%	1.45%	-8.53%
Efficiency ratio (2)	92.84%	98.13%	87.24%	92.44%	154.65%
<b>ASSET QUALITY RATIOS:</b>					
Allowance for loan losses to period end loans	0.99%	0.91%	0.71%	0.79%	1.02%
Allowance for loan losses to nonperforming assets	1049.57%	784.83%	n/a	n/a	n/a
Nonperforming assets to period end loans and foreclosed properties	0.09%	0.12%	n/a	n/a	n/a
Net charge-offs to average loans	0.19%	0.06%	0.04%	0.03%	0.00%
<b>CAPITAL AND LIQUIDITY RATIOS:</b>					
Leverage	10.94%	12.13%	14.14%	18.30%	26.05%
Risk Based Capital Ratios:					
Tier 1 capital	15.48%	17.51%	20.18%	23.62%	32.27%
Total capital	16.10%	18.26%	20.77%	24.32%	33.20%
Average loans to average deposits	67.40%	65.28%	66.93%	83.06%	80.13%

(1) Net interest margin is calculated as fully taxable equivalent net interest income divided by average earning assets and represents the Bank's net yield on its earning assets.

(2) Efficiency ratio is computed by dividing non-interest expense less foreclosed property expense by the sum of fully taxable equivalent net interest income and non-interest income, net of securities gains or losses.

(3) The Bank had no nonperforming loans or foreclosed properties in 2006, 2005 or 2004.

## **CAUTION ABOUT 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 “the Bank expects,” “the Bank believes” or words of similar import.

Such forward-looking statements involve known and unknown risks including, but not limited to, the following factors:

- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- the successful management of interest rate risk;
- changes in general economic and business conditions in the Bank’s market area;
- the ability to continue to attract low cost core deposits to fund asset growth;
- reliance on the Bank’s management team, including its ability to attract and retain key personnel;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- managing the cost and implementation on new technology required to compete and to meet increasing regulatory requirements
- the ability to successfully manage the Bank’s growth or implement its growth strategies if it is unable to identify attractive markets, locations or opportunities to expand in the future;
- changing trends in customer profiles and behavior;
- changes in banking and other laws and regulations applicable to the Bank;
- demand, development and acceptance of new products and services; and
- maintaining capital levels adequate to support the Bank’s growth.

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

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with the financial statements, accompanying notes and selected financial data appearing elsewhere in this Annual Report on Form 10-K and may contain certain forward-looking statements that are based on current management expectations. Generally, verbs in the future tense and the words, "believe," "expect," "anticipate," "intends," "opinion," "potential" and similar expressions identify forward-looking statements. Examples of this forward-looking information can be found in, but are not limited to, the expected effects of accounting pronouncements and government regulation applicable to the Bank's operations, the discussion of allowance for loan losses, litigation and any quantitative and qualitative disclosure about market and interest rate risk. The actual results of the Bank could differ materially from those management expectations. The forward-looking statements contained herein speak only as of the date of this Annual Report on Form 10-K, and, except as may be required by applicable law and regulation, the Bank does not undertake, and specifically disclaims any obligation, to publicly update or revise such statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.*

### **Overview**

The Bank is headquartered in Gloucester, Virginia and conducts its primary operations through the Bank. The Bank is a community bank principally serving the Virginia county of Gloucester, but also providing banking services in the overall market known as the Middle Peninsula, as well as the Peninsula. The Bank also has an investment division operating under the name of Colonial Virginia Investment Services. The Bank began offering a full suite of mortgage services October 1, 2006, through Colonial Virginia Mortgage, LLC ("CVM"). CVM is owned jointly with Johnson Mortgage Company, LLC, of Newport News, Virginia, and each owner possesses 50% ownership. CVM was capitalized with \$250,000, with each owner contributing \$125,000. CVM makes and sells whole loans, and it is believed to be a good complement to the Bank's overall lending program by expanding the suite of loan products to include fixed rate permanent mortgage loans. A significant enhancement to the Bank's construction lending practices will be the ability to offer single closing construction to permanent mortgage lending. This feature is attractive among customers for convenience and reduced overall costs.

The Bank's results of operations are primarily dependent on net interest income, which is the difference between the income earned on loans and the investment portfolio and the cost of funds, consisting of the interest paid on deposits and borrowings. Results of operations are also affected by the allowance for loan losses and non-interest income from such activities as investment and mortgage services and other customer service fees. Non-interest expense principally consists of salaries and benefits, occupancy and equipment expenses, business development costs, professional fees, data processing expense and other expenses.

### **Critical Accounting Policies**

#### *General*

The financial condition and results of operations presented in the Financial Statements, the accompanying Notes to Financial Statements and this section are, to a large degree, dependent upon the accounting policies of the Bank. 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 (“Critical Accounting Policies”) to the portrayal and understanding of the Bank’s financial condition and results of operations. The 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 a materially different financial condition or results of operations is a reasonable likelihood.

#### *Allowance for Loan and Lease Losses*

The Bank monitors and maintains an allowance for loan and lease losses (“ALLL”) to absorb an estimate of probable losses inherent in the loan portfolio. The Bank maintains 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 that the systems are maintained in accordance with accounting principles generally accepted in the United States of America; the accounting policies for loan charge-offs and recoveries; the assessment and measurement of impairment in the loan portfolio; and the loan grading system. The Bank uses an internal risk rating system and assigns a numeric rating to each loan based on multiple criteria, including but not limited to a borrower’s credit history (evidenced by credit bureau reporting), collateral and its supporting value, type of work or industry in which the borrower is involved, and any noted exceptions to internal policy. Varying percentages of outstanding balances by risk rating are used in determining the adequacy of the ALLL.

The ALLL consists of two components, allocated and unallocated. The Bank evaluates various loans individually for impairment as required by Statement of Financial Accounting Standards (“SFAS”) No. 114, *Accounting by Creditors for Impairment of a Loan*, and SFAS No. 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 No. 5, *Accounting for Contingencies* (“SFAS 5”), with a group of loans that have similar characteristics.

For loans without individual measures of impairment, the Bank makes 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 grade 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 are adjusted for relevant environmental factors and other conditions of the portfolio of loans, including: borrower and industry concentrations; levels and trends in delinquencies, charge-offs and recoveries; changes in underwriting standards and risk selection; level of experience, ability and depth of lending management; and national and local economic conditions.

The amounts of estimated impairment for individually evaluated loans and groups of loans are added together for a total estimate of loan losses. This estimate of losses is compared to the allowance for loan losses of the Bank 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. The Bank recognizes 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.

## **Executive Overview**

The financial sector continues under tremendous pressure from major loan loss and other asset quality concerns, as well as the compression of net interest margins. The Bank does not suffer from such asset quality issues or loan charge-offs and, in fact, enjoys a strong loan portfolio with minimal delinquencies and insignificant loss exposure. The Bank has not been caught up in the sub-prime mortgage crisis or the debacle of problem real estate development loans. The Bank has cautiously targeted growth that not only attempts to maximize net interest margins, but also protects overall asset quality. While there was much publicity of the “bailout” of the financial services industry and the Troubled Asset Relief Program (“TARP”), the Bank elected not to apply for or participate in this program. The Board of Directors and management determined that more traditional means of capital generation (i.e. issuance of common stock and/or retained earnings) were more appropriate for the long-term strategic plans of the Bank. The Bank is also more than adequately capitalized for both the current balance sheet, as well as growth for the foreseeable future.

In light of the collapse of the Federal National Mortgage Association (“FNMA”) and the Federal Home Loan Mortgage Corporation (“FHLMC”), it is important to note that the Bank did not hold any stock (common or preferred) in either of these government sponsored enterprises (“GSE”). The Bank does hold mortgage-backed securities issued by both FNMA and FHLMC; however, the federal government has taken over both entities and guaranteed these bond issues. Management has increased its scrutiny when purchasing mortgage-backed securities with more emphasis on geographical distribution of the mortgages and avoiding areas of the country where mortgage foreclosures are significantly higher. In addition, bonds issued in 2003 and prior, with amortizing repayment schedules, are considered to be more acceptable risks since the underlying mortgages would have originated prior to the much publicized “real estate bubble.” Newer issued mortgage-backed bonds are being considered when the underlying collateral is 10 year amortizing loans, since the credit underwriting standards are much more stringent for individual applicants, adding stability to the cash flows of these bonds.

Net income of \$134,938 or \$0.22 per share assuming dilution, was recorded for the year ended December 31, 2008, compared with \$97,307, or \$0.16 per share assuming dilution, for the year ended December 31, 2007.

For the years ended December 31, 2008 and 2007, gross revenues, which are defined as interest income plus other income, were \$6.9 million and \$6.5 million, respectively, while gross expenses, which are defined as interest expense plus other expenses, the provision for loan losses and the provision for income taxes, were \$6.8 million and \$6.4 million, respectively.

Total average assets increased 16.2% from the December 31, 2007 amount of \$89.5 million to \$104.0 million at December 31, 2008. Average shareholders’ equity increased 2.7% to \$11.6 million in 2008. Return on average assets and equity at December 31, 2008 were 0.13% and 1.17%, respectively.

Total assets for the Bank increased to \$110.8 million at December 31, 2008, compared to \$95.5 million at December 31, 2007, representing an increase of \$15.3 million or 16.0%. Total net loans at December 31, 2008 were \$62.1 million, an increase of \$8.4 million, or 15.6%, from the December 31, 2007 amount of

\$53.7 million. The provision for loan losses in 2008 was \$239,200, compared to \$190,700 in 2007. The allowance for loan and lease losses totaled \$622,068 or 0.99% of total loans outstanding at December 31, 2008 and \$491,383 or 0.91% of total loans outstanding at December 31, 2007.

The investment portfolio decreased 8.8% to \$27.1 million at December 31, 2008 compared to \$29.7 million at December 31, 2007. Despite continued purchase activity throughout 2008, there were multiple reasons for the decline. In the midst of the falling interest rate environment, the Bank experienced significant “call” activity, with bond issuers exercising their option to pay the bonds in advance of stated maturities. The falling rate environment also created substantial increases in market values of the majority of the Bank’s bonds. Management made a strategic decision in December 2008 to sell a portion of the portfolio to recognize additional income gains. These sales also provided additional balance sheet liquidity. This afforded the Bank the opportunity to allow higher cost certificates of deposits (“CDs”) to mature and not be renewed, discussed elsewhere in this report. Management continues an investment strategy of employing excess liquidity in securities with yields that will enhance overall interest earnings without creating undue extension or interest rate risk. Extension risk is the potential for actual cash flows to either lengthen or shorten compared to projected cash flows based on interest rate fluctuations. The Bank continues its posture of not attempting to forecast interest rates in a vacuum. Fluctuations in the market value of the Bank’s portfolio have increased the Bank’s unrealized gain position on securities available for sale of \$168,579, net of taxes, at December 31, 2007 to \$397,211, net of taxes, at December 31, 2008. The level of extension, interest rate and market value risk are considered manageable relative to overall balance sheet management. The Bank does not rely on funds from the bond portfolio for primary liquidity beyond the respective cash flows and maturities of individual bonds.

The composition of the Bank’s investment securities portfolio reflects the Bank’s investment strategy of maximizing portfolio yields commensurate with risk and liquidity considerations. The primary objectives of the Bank’s investment strategy are to maintain an appropriate level of liquidity and to provide a tool to assist in controlling the Bank’s interest rate sensitivity position while, at the same time, producing adequate levels of interest income. The Bank’s investment securities are classified into one of two categories based upon Management’s intent to hold the investment securities: (i) investment securities held to maturity or; (ii) investment securities available for sale. Investment securities held in a trading account are required to be reported at fair value, with unrealized gains and losses included in earnings. Investment securities designated to be held to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, with such amortization and accretion being determined by the interest rate method. The Bank has the ability, and it is Management’s intention, to hold these securities to maturity. Management of the maturity of the portfolio is necessary to provide liquidity and control interest rate risk. Investment securities available for sale are recorded at fair value. Increases and decreases in the net unrealized gain or loss on the investment securities available for sale portfolio are reflected as adjustments to the carrying value of the portfolio and as an adjustment, net of tax, to accumulated other comprehensive income.

Fair values of investment securities available for sale are based primarily on quoted or other independent market prices. If quoted market prices are not available, then fair values are estimated using pricing models, quoted prices of instruments with similar characteristics or discounted cash flows.

Total deposits increased \$3.9 million to \$86.8 million at December 31, 2008 from \$82.9 million at December 31, 2007. Of the total deposit level, time deposits totaled \$62.6 million at December 31, 2008, a decrease of \$0.2 million from \$62.8 million at December 31, 2007.

The Bank continued to experience constant pricing pressure during most of 2008 from large national banks that were experiencing internal liquidity demands as the banking crisis grew and public confidence waned amongst the nation’s largest financial institutions. This pricing pressure was a constant

challenge to the Bank's net interest margin goals. Therefore, the Bank selectively allowed more expensive time deposits to be redeemed without renewal. Alternative funding sources are discussed elsewhere in this report.

Shareholders' equity was \$11.9 million at December 31, 2008. This amount represents an increase of 3.5% from the December 31, 2007 amount of \$11.5 million. The book value per common share was \$19.51 at December 31, 2008 and \$18.86 at December 31, 2007.

Growth levels continue to be encouraging. The composition of balance sheet growth was initially more commercial than consumer in nature, which has reflected lower than expected yields in the loan portfolio. Pricing practices have continued to be more aggressive in an effort to maximize loan yields. While this aggressive lending posture is intended to enhance overall asset yield and resultant net interest income, management has maintained credit quality at the forefront of its underwriting practices. The Bank's initial investment in experienced lending personnel should aid in this effort to closely manage asset quality.

### **Net Interest Income**

Net interest income is the Bank's primary source of earnings and represents the difference between interest and fees earned on earning assets and the interest expense paid on deposits and other interest bearing liabilities. Net interest income totaled \$3.3 million for the year ended December 31, 2008, compared to \$3.1 million for the year ended December 31, 2007. Average earning assets increased \$14.2 million from \$81.1 million for the year ended December 31, 2007 to \$95.3 million for the year ended December 31, 2008. Average deposits and short-term borrowings increased \$13.9 million from \$77.4 million for the year ended December 31, 2007 to \$91.3 million for the year ended December 31, 2008. Total interest expense was \$3.2 million for the year ended December 31, 2008, compared to \$3.1 million for the year ended December 31, 2007. The net interest margin (net interest income expressed as a percentage of average earning assets)("NIM"), on a tax equivalent basis, was 3.43% for the year ended December 31, 2008 compared to 3.81% for the year ended December 31, 2007.

The cause of the compression of the NIM is multi-fold. Since the third quarter of 2007, the Federal Open Market Committee of the Federal Reserve System ("FOMC") has slashed short-term interest rates a total of 325 basis points in response to a nationwide concern over the economy, specifically the sub-prime mortgage sector, and the liquidity crisis among large mortgage lenders and investment firms, such as Bear Stearns in New York. The FOMC cut rates 100 basis points between September 18 and December 11, 2007. Then, in a dramatic and unprecedented move, the FOMC exercised an emergency rate cut of 75 basis points January 22, 2008, followed by a 50 basis point cut at its regular meeting January 30, 2008. Subsequent to those cuts, an additional rate cut of 75 basis points was implemented March 18, 2008, with another 25 basis point cut April 30, 2008. This immediately reduced the yield of approximately \$31.0 million in variable rate loans, while a significant volume of CDs with original maturities of 17 to 21 months continued to reprice upwards through the first few months of 2008, due to renewal rates that were still in excess of origination rates, despite the declining rate environment. In effect, the cost of funds was increasing, despite decreasing rates on immediately repricing assets in both the loan and bond portfolios. The Bank attempted, during the second half of 2007, to purchase investments with maturities and/or call features that protected against falling interest rates. This strategy did soften the NIM compression, but subsequent calls did occur in 2008, continuing the stress on the NIM. Mitigating this compression of the NIM is the repricing opportunities of three year adjustable rate mortgages ("ARMs") originated by the Bank in 2005 which reflected upward re-pricing during 2008.

The Bank has practiced the "flooring" of variable rate loans (contractually limiting how much the individual loan rate can decrease regardless of decreases in market rates) which has mitigated the sharp

rate decreases by the FOMC, as several variable rate loans have reached their floor rate during 2008 and have not continued to suffer declining yields. The duration of the negative impact of falling rates on net interest income is measurable and quantifiable through interest rate risk models used by the Bank. In fact, on a monthly basis, the Bank's net interest income began to increase as higher fixed rate CDs were repricing downward in the second half of 2008.

The Bank's absolute volume of earning assets is below its desired level for long-term balance sheet management. It is noted that by opening the Bank with two offices at the same time and completing the permanent buildings for both locations in 2005, substantial amounts of investment funds were directed to fixed assets (non-earning assets). These offices are spacious, modern facilities and are considered to position the Bank well for expanded operations well into the future. Management continues its focus on increasing earnings assets as a percentage of total assets.

The Bank utilizes asset liability management modeling software to assist in the identification and management of interest rate risk. This software provides tools for identifying repricing intervals, maturities, and cash flows of interest earning assets and interest bearing liabilities. In addition, income simulations are performed applying interest rate shocks to interest sensitive assets and liabilities. Modeling techniques are designed to enable the Bank to minimize significant swings or variations in net interest income during periods of substantial fluctuations in market rates. The Bank does not specifically attempt to predict interest rate movements. It is, however, important to point out that the Bank is not immune to both market rates in general and the shape of the market's yield curve or the slope of the graph that plots interest rates over time. The effect and impact of the yield curve on maturing assets and liabilities can be profound when the yield curve is "inverted" which means that interest rates which normally increase over extended time horizons instead are higher in the shorter term maturities and lower in longer term maturities. The Bank's model is able to forecast repricing symmetry or asymmetry of administered deposits, such as money market, NOW and savings. The Bank's current repricing of these deposits is considered asymmetrical representing a modest deposit pricing disadvantage. This is because, given a hypothetical 100 basis point increase in market rates, the Bank might require a corresponding 50 to 75 basis point increase in rates paid for these deposit types, while given a similar hypothetical 100 basis point decrease in market rates, the Bank would more likely only be able to reduce the rates paid on these deposit types by 25 to 50 basis points. Therefore, a decrease in rates would result in compression of the NIM and decrease net interest income.

The Bank's balance sheet structure has evolved into a moderately asset sensitive condition. This condition means that assets may reprice more quickly than liabilities and, in a rising rate environment, interest income would increase more quickly than interest expense. Conversely, when interest rates fall, interest income would decrease more quickly than interest expense. Through the use of the modeling techniques mentioned above, Management is closely monitoring the volumes of interest bearing liabilities that are scheduled for repricing within the next 90 day, 180 day and one year intervals. The Bank markets 10 and 13 month CDs to manage the interest rate risk associated with being asset sensitive, should the FOMC actually decrease short-term rates within the next twelve months. The Bank also continues its practice of including interest rate floors in new variable rate loan instruments. This measure is designed to guard against exposure to reduced interest income associated with possible falling rates in the future.

### **Non-interest Income**

Non-interest income totaled \$491,353 for the year ended December 31, 2008, compared to \$264,196 for the year ended December 31, 2007. The primary components of non-interest income include service charges on deposit accounts, ATM and debit card transaction fees, commissions on credit life insurance, checkbook sales, title insurance and net gains (losses) on the sale of repossessions and net gains (losses) on securities.

Service charges on deposit accounts totaled \$86,543 for the year ended December 31, 2008, compared to \$87,475 for the year ended December 31, 2007. Net gain on securities totaled \$206,813 for the year ended December 31, 2008, compared to \$2,016 for the year ended December 31, 2007. Some of these gains were the result of bonds, purchased originally at a discount from par value, that were called prior to maturity with redemption amounts at par value. During the fourth quarter of 2008, the Bank sold approximately \$6.9 million in securities, recognizing a cumulative net gain of slightly more than \$139,000. In 2008, net revenue from the Bank's investment division totaled \$36,801.

The Bank's mortgage subsidiary, CVM, is projected initially to experience minimal net operating losses due to start-up costs and personnel overhead until mortgage originations reach an average critical mass level of approximately \$10 million annually. CVM's projected income is expected to enhance the Bank's non-interest income. In addition, the Bank will provide a portion of CVM's warehouse line of credit. This line of credit will enable CVM to fund its mortgages at closing until they are sold to secondary market investors, a period which is typically seven to twenty-five days. This practice is expected to enhance the Bank's interest income. Income from the mortgage division totaled \$14,387 in 2008. Although the absolute level of income from CVM is slightly disappointing, many mortgage companies have become severely unprofitable and have even failed. The broad nationwide softening of mortgage loan originations has inhibited general growth of CVM's mortgage operations. The Bank is, however, confident that CVM will continue to contribute to long-term non-interest income, as well as compliment total product offerings and expand customer relationships.

### **Non-interest Expense**

Non-interest expense includes employee-related costs, occupancy and equipment expense and other overhead. Total non-interest expense remained constant at \$3.3 million in 2008 and 2007.

Salaries and employee benefits totaled \$1.8 million in the year ended December 31, 2008, compared to \$1.6 million for the year ended December 31, 2007.

Strategic competitive decisions at the Bank's inception were made regarding product offerings, such as internet and telephone banking, ATM and debit cards, check imaging and optical file storage, all of which resulted in substantial initial investment in technology. These technology decisions are expected to produce long-term efficiencies and competitive necessities. However, such initial financial investments require more critical mass of customer accounts when such a heavy reliance is placed on net interest income for overall profitability.

As discussed further below in Item 9A, Controls and Procedures, the Bank became subject to full compliance in 2007 to the Sarbanes-Oxley Act of 2002 ("SOX"). Specifically, Section 404 of SOX requires a much expanded validation of the Bank's systems of internal controls over financial reporting compared to the current environment in which the Bank operates. In 2008, the Bank expensed \$45,379 for audit services directly associated with SOX compliance, compared to \$28,324 expensed in 2007.

### **Non-GAAP Financial Measures**

A measure of the extent to which the Bank's revenues are absorbed by non-interest expenses is expressed as the efficiency ratio. The efficiency ratio is calculated by dividing non-interest expenses by the sum of total non-interest income and net interest income for the period. This is a non-GAAP financial measure, which we believe provides important information about our operational efficiency. Comparison of our efficiency ratio with those of other companies may not be possible because other companies may calculate the ratio differently. As a de novo bank, it is expected that this ratio will be extremely high in the early period of operation due to the myriad of startup expenses. As the Bank matures, an efficiency

ratio of 60 to 65% is targeted. At December 31, 2008, the Bank's efficiency ratio was 92.84% compared to 98.13% at December 31, 2007.

Still another indicator of the appropriate use of personnel is the measurement of assets expressed as millions of dollars of assets per employee. This measurement was \$4.1 million per employee at December 31, 2008, compared to \$3.5 million at December 31, 2007. Unfortunately, due to the demands of increased levels of internal control associated with SOX (discussed elsewhere in this report), the Bank may have to increase staff in operational areas in the future. Management, up to this point, has attempted to offset the need for staff through the use of technology.

### **Allowance for Loan and Lease Losses**

The allowance for loan and lease losses ("ALLL") at December 31, 2008 was \$622,068, compared to \$491,383 at December 31, 2007. The allowance for loan losses was 0.99% of total loans outstanding at December 31, 2008, compared to 0.91% at December 31, 2007. The provision for loan losses was \$239,200 for the year ended December 31, 2008, compared to \$190,700 for the year ended December 31, 2007. The provision for loan and lease losses represents Management's judgment of the current period cost of credit risk inherent in the Bank's loan portfolio. Specifically, the provision represents the amount charged against current period earnings to achieve an allowance for potential losses that, in Management's judgment, is adequate to absorb probable losses inherent in the Bank's loan portfolio. Accordingly, the provision expense will vary from period to period based on Management's ongoing assessment of the adequacy of the ALLL. In 2007, Management became more aggressive in its ALLL adequacy methodology regarding risk assessment of unsecured credit as well as general economic conditions. This resulted in a demand for increased provision for loan loss expense, although the level of imbedded risk in the portfolio and more specifically the level of impaired loans is considered relatively stable. Additionally, Management added more stratification to the segment of the ALLL calculation which addresses local economic conditions. These factors include unemployment levels, median house prices, median income levels and residential housing permits, to name a few. The Bank has not been affected by the nationwide "sub-prime" mortgage crisis since it is not active in sub-prime lending. Management believes that the ALLL is adequate to cover credit losses inherent in the loan portfolio at December 31, 2008. Loans past due, 90 days and over, totaled \$91,342 at December 31, 2008, compared to \$8,864 at December 31, 2007. Repossessions totaled \$0 at December 31, 2008, compared to \$55,000 at December 31, 2007. Despite these somewhat negative trends, Management does not anticipate material losses in either of these categories.

Management uses an internal credit risk rating system which includes six "pass" grades, as well as four adverse grades. All existing loans have been assigned an individual risk rating. Management not only incorporates these ratings into its methodology for evaluating the adequacy of the ALLL, but also into pricing strategies. This methodology also reflects the provision for loan loss expense to accommodate only the risks associated with this evaluation exercise.

### **Capital Resources**

Shareholders' equity at December 31, 2008 and December 31, 2007 was \$11.9 million and \$11.5 million, respectively. The 2008 amount includes "accumulated other comprehensive income" of \$307,708. This amount is comprised of a credit amount of \$397,211 of unrealized gains on available for sale securities, net of tax, and \$89,504 representing the unamortized debit balance on a one-time lump sum adjustment to accrued pension liability pursuant to SFAS No. 158, net of tax (discussed elsewhere in this report). Total common shares outstanding at December 31, 2008 were 610,175.

At December 31, 2008, the Bank's tier 1 and total risk-based capital ratios were 15.5% and 16.1%, respectively, compared to 17.5% and 18.3% at December 31, 2007. The Bank's leverage ratio was 10.9% at December 31, 2008, compared to 12.1% at December 31, 2007. The Bank raised in excess of \$12.0 million in initial capital prior to opening, resulting in skewed capital ratios, compared to industry averages, until such time as the Bank's asset base grows to fully leverage initial capital. The Bank's capital structure places it above the regulatory guidelines, which affords the Bank the opportunity to take advantage of business opportunities while ensuring that it has the resources to protect against risk inherent in its business. This level of capital also provides sufficient resources during the business development stage.

### **Liquidity and Interest Rate Sensitivity**

The primary functions of asset and liability management are to (1) assure adequate liquidity; (2) maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities; (3) maximize the profit of the Bank; and (4) reduce risks to the Bank's capital. Liquidity management involves the ability to meet day-to-day cash flow requirements of the Bank's customers, whether they are depositors wishing to withdraw funds or borrowers requiring funds to meet their credit needs. Without proper liquidity management, the Bank would not be able to perform the primary function of a financial intermediary and would, therefore, not be able to meet the needs of the communities it serves. Management believes that the Bank maintains overall liquidity sufficient to satisfy its depositors' requirements and to meet its customers' credit needs. Interest rate risk management focuses on the maturity structure of assets and liabilities and their repricing characteristics during changes in market interest rates. Effective interest rate sensitivity management ensures that both assets and liabilities respond to changes in interest rates within an acceptable time frame, thereby minimizing the effect of such interest rate movements on the net interest margin.

The asset portion of the balance sheet provides liquidity primarily from two sources. These sources are principal payments and maturities and sales relating to loans, and maturities and principal payments from the investment portfolio. Other short-term investments such as federal funds sold are additional sources of liquidity. Loans, maturing or repricing in one year or less, totaled \$30.5 million at December 31, 2008. Investment securities that are forecast to mature or reprice over the next twelve months total \$6.2 million, or 23.8% of the investment portfolio as of December 31, 2008.

Although the majority of the securities portfolio has legal final maturities longer than 10 years, the entire portfolio consists of securities that are readily marketable and easily convertible into cash. As of December 31, 2008, due to call options, scheduled principal payments, and projected pre-payments, the bond portfolio had an expected average maturity of approximately slightly in excess of three years, with approximately 77% expected to be repaid within 5 years. However, Management does not rely solely upon the investment portfolio to generate cash flows to fund loans, capital expenditures, dividends, debt repayment, and other cash requirements. Instead, these activities are funded by cash flows from operating activities and increases in deposits and short-term borrowings.

The liability portion of the balance sheet provides liquidity through interest bearing and non-interest bearing deposit accounts.

The Bank also maintains additional sources of liquidity through federal funds guidance lines with correspondent banks, which totaled \$7.1 million at December 31, 2008. The Bank terminated its previous arrangement with QwickRate, a nationally organized program whereby financial institutions may publish interest rates for CDs of various maturities and attract deposits from other investors (predominantly credit unions). To replace this potential funding source, the Bank joined the Federal Home Loan Bank of Atlanta ("FHLB") in the fourth quarter of 2007. The Bank has various borrowing options through the

FHLB, although such borrowings require collateralization by means of pledging investment securities or certain loans secured by real estate. The Bank actually began exercising options under the FHLB line of credit during 2008. Management used advances under the line as replacement for more expensive consumer CDs in the local market. FHLB borrowings totaled \$11.0 million at December 31, 2008.

At December 31, 2008, cash, interest bearing deposits with financial institutions, federal funds sold and securities available for sale were 39.4% of total deposits and liabilities. Management, under a Board approved Liquidity and Funding Policy, routinely monitors the Bank's liquidity position using various schedules and reports. A "Short-term Funds Availability Ratio" computes short-term assets (cash and due from banks, overnight funds and other cash equivalents, market value of available for sale securities, and unused lines of credit). The policy requires that this ratio be equal to or greater than 15% of total assets. At December 31, 2008, this ratio was 42.8%. Core deposit levels are also monitored. Demand and savings deposits, interest bearing and non-interest bearing, time deposits under \$100,000 and other borrowings are monitored with a targeted level of 52.5% or greater as a percentage of total assets. At December 31, 2008, this percentage was 54.2%.

In 2007, the Bank began participating in a CD program with the Treasurer of Virginia, administered through Community Bankers Bank of Virginia ("CBB"). Due to the fact that CBB manages this program for the State of Virginia, these deposits are considered "brokered" deposits. As of December 31, 2008, the Bank held \$3.1 million of these CD funds. The Bank holds other brokered deposits totaling \$6.1 million as of December 31, 2008.

#### **Off-Balance Sheet Arrangements**

The Bank 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. These financial instruments include loan commitments, standby letters of credit and documentary letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the financial statements.

The Bank's exposure to credit loss in the event of non-performance by the other party of these loan commitments and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Since many of the loan commitments and letters of credit may expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, owner-occupied real estate and income-producing commercial properties.

The Bank maintains funds on deposit at correspondent banks which at times exceed the federally insured limits. Management of the Bank monitors the balance in these accounts and periodically assesses the financial condition of correspondent banks. The Bank has expanded its continuous monitoring of the financial condition of all of the correspondent banks with which it does business. Both current data and trend analysis are monitored for key financial ratios such as asset quality, earnings and capital. In a move to enhance the strength of the financial services industry, the FDIC implemented the Temporary Liquidity Guarantee Program ("TLGP") in October 2008. This essentially provided expanded insurance coverage for 100% non-interest bearing transactions, such as the Bank maintains with its correspondent banks. The two primary correspondent accounts are with Compass Bank and Community Bankers Bank ("CBB"),

both of whom are participants in the FDIC's TLGP. Therefore, the Bank considers its level of risk with these correspondent banks to be manageable.

### **Future Events and Other Matters**

The Bank will roll out its remote merchant deposit capture for its commercial customers in April 2009. This product will enhance the Bank's ability to attract valuable new commercial deposits from areas where the Bank has no physical presence by allowing "non-cash" deposits to be transmitted electronically, eliminating the need for the commercial customer to come to the Bank. Because other competitors have gradually begun to offer similar products, the Bank also believes that such a step is needed to retain existing valuable commercial customers.

### **CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the Bank carried out an evaluation, under the supervision and with the participation of the Bank's management, including the Bank's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Bank's disclosure controls and procedures pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, the Bank's Chief Executive Officer and Chief Financial Officer concluded that the Bank's disclosure controls and procedures are effective in timely alerting them to material information relating to the Bank required to be included in the Bank's periodic filings with the Board of Governors of the Federal Reserve System.

Management is responsible for establishing and maintaining adequate internal controls over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act.

In order to evaluate the effectiveness of internal control over financial reporting, as required by Rule 13(a)-15(c) of the Exchange Act, management conducted an assessment using the criteria established in *Internal Control – Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that as of December 31, 2008, our internal control over financial reporting was effective.

This annual report does not include an attestation report of the Bank's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Bank's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

There were no changes in the Bank's internal control over financial reporting identified in connection with the evaluation of it that occurred during the quarter that ended December 31, 2008 that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

**AVERAGE BALANCES, INTEREST INCOME  
AND EXPENSES, AVERAGE YIELDS AND RATES**

	Year Ended December 31, 2008			Year Ended December 31, 2007		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<b>Assets:</b>						
Interest earning assets:						
Securities						
Taxable	\$31,544,590	\$ 1,686,371	5.35%	\$23,756,233	\$1,249,201	5.26%
Total securities	31,544,590	1,686,371	5.35%	23,756,233	1,249,201	5.26%
Federal funds sold	3,636,748	85,334	2.35%	7,698,161	396,230	5.15%
Deposits at other banks	1,864,711	28,528	1.53%	--	--	--
Loans, net	58,224,885	4,630,892	7.95%	49,690,083	4,574,446	9.21%
Total earning assets	95,270,934	6,431,125	6.75%	81,144,477	6,219,877	7.67%
Less: allowance for loan losses	(533,355)			(348,550)		
Total non-earning assets	9,235,486			8,732,791		
Total assets	103,973,065			89,528,718		
<b>Liabilities and Stockholders' Equity:</b>						
Interest bearing liabilities:						
Checking	4,056,411	59,252	1.46%	3,605,565	53,296	1.48%
Savings and money market deposits	10,550,946	218,617	2.07%	11,580,932	245,608	2.12%
Other time	64,508,999	2,763,254	4.28%	55,066,253	2,832,625	5.14%
Total interest bearing deposits	79,116,356	3,041,122	3.84%	70,252,750	3,131,529	4.46%
FHLB borrowings	4,923,169	125,934	2.56%	--	--	--
Total interest bearing liabilities	84,039,525	3,167,056	3.77%	70,252,750	3,131,529	4.46%
Noninterest bearing liabilities:						
Demand deposits	7,275,077			7,102,908		
Other non-interest bearing Liabilities	1,083,555			895,571		
Total liabilities	92,398,157			78,251,229		
Stockholders' equity	11,574,908			11,277,489		
Total liabilities and stockholders' equity	\$103,973,065			\$89,528,718		
Net Interest Income		\$ 3,264,069			\$3,088,348	
Interest rate spread <sup>(1)</sup>			2.98%			3.21%
Net Interest Margin <sup>(2)</sup>			3.43%			3.81%

<sup>(1)</sup> Interest spread is the average yield earned on earning assets, calculated on a fully taxable equivalent basis assuming a federal tax rate of 34%, less the average rate incurred on interest-bearing liabilities.

<sup>(2)</sup> Net interest margin is the net interest income, expressed as a percentage of average earning assets.



## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
Colonial Virginia Bank  
Gloucester, Virginia

We have audited the accompanying balance sheets of Colonial Virginia Bank as of December 31, 2008 and 2007, and the related statements of income, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these 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 audit 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 financial statements referred to above present fairly, in all material respects, the financial position of Colonial Virginia Bank as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

We were not engaged to examine management's assessment of the effectiveness of Colonial Virginia Bank's internal control over financial reporting as of December 31, 2008, included in the accompanying Management's Report on Internal Control over Financial Reporting and, accordingly, we do not express an opinion thereon.

*Yount, Hyde & Barbour, P.C.*

Winchester, Virginia  
March 25, 2009

**COLONIAL VIRGINIA BANK**  
**Balance Sheets**  
December 31, 2008 and 2007

<b>Assets</b>	<b>2008</b>	<b>2007</b>
	<u>                    </u>	<u>                    </u>
Cash and due from banks	\$ 10,116,510	\$ 2,174,513
Federal funds sold	3,825,000	2,756,458
Securities available for sale, at fair market value	26,347,158	26,533,407
Securities held to maturity (fair market value of \$807,289 in 2008 and \$3,227,514 in 2007)	790,373	3,203,906
Loans, net of allowance for loan losses of \$622,068 in 2008 and \$491,383 in 2007	62,120,125	53,658,504
Bank premises and equipment, net	3,987,464	3,753,744
Bank owned life insurance	2,618,333	2,089,533
Other assets	<u>966,939</u>	<u>1,290,036</u>
 Total assets	 <u>\$ 110,771,902</u>	 <u>\$ 95,460,101</u>
 <b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 7,187,310	\$ 6,779,679
Savings and interest-bearing demand deposits	17,026,196	13,376,847
Time deposits	<u>62,575,457</u>	<u>62,792,174</u>
Total deposits	\$ 86,788,963	\$ 82,948,700
Federal Home Loan Bank borrowings	11,000,000	--
Accrued expenses and other liabilities	<u>1,081,168</u>	<u>1,005,448</u>
Total liabilities	<u>\$ 98,870,131</u>	<u>\$ 83,954,148</u>
 <b>Shareholders' Equity</b>		
Preferred stock, par value \$5 per share, authorized 5,000,000 shares; no shares issued and outstanding	\$ --	\$ --
Common stock, par value \$5 per share, authorized 10,000,000 shares; issued and outstanding 610,175 shares	3,050,875	3,050,875
Capital surplus	9,132,538	9,130,243
Retained (deficit)	(589,350)	(724,288)
Accumulated other comprehensive income	<u>307,708</u>	<u>49,123</u>
Total shareholders' equity	<u>\$ 11,901,771</u>	<u>\$ 11,505,953</u>
 Total liabilities and shareholders' equity	 <u>\$ 110,771,902</u>	 <u>\$ 95,460,101</u>

See Accompanying Notes to Financial Statements.

## COLONIAL VIRGINIA BANK

### Statements of Income

For the Years Ended December 31, 2008 and 2007

	2008	2007
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 4,630,892	\$ 4,574,446
Interest on securities		
Taxable	1,652,142	1,228,830
Dividends	34,229	20,371
Interest on federal funds sold	113,862	396,230
Total interest and dividend income	\$ 6,431,125	\$ 6,219,877
<b>Interest Expense</b>		
Interest on deposits	\$ 3,041,122	\$ 3,131,529
Interest on FHLB borrowings	125,934	-
Total interest expense	\$ 3,167,056	\$ 3,131,529
Net interest income	\$ 3,264,069	\$ 3,088,348
<b>Provision for Loan Losses</b>	239,200	190,700
Net interest income after provision for loan losses	\$ 3,024,869	\$ 2,897,648
<b>Other Income</b>		
Service charges on deposit accounts	\$ 86,543	\$ 87,475
Income on bank owned life insurance	28,800	39,943
Net gain (loss) on sale of repossessions	500	(10,000)
Net gain on securities	206,813	2,016
Other service charges, commissions and fees	168,697	144,762
Total other income	\$ 491,353	\$ 264,196
<b>Other Expenses</b>		
Salaries and employee benefits	\$ 1,779,178	\$ 1,648,545
Occupancy expense	204,362	194,009
Furniture and equipment expense	85,411	69,867
Data processing	469,163	437,030
Advertising	125,402	137,023
Professional fees	172,730	110,168
Stationery and supplies	40,024	41,368
Postage and freight	35,419	35,843
Regulatory assessments	88,081	63,079
Insurance	36,302	35,913
Franchise tax	65,177	62,418
Directors fees	74,400	68,200
Charitable contributions	19,880	314,983
Other operating expenses	99,081	69,406
Total other expenses	\$ 3,294,610	\$ 3,287,852

See Accompanying Notes to Financial Statements.

## COLONIAL VIRGINIA BANK

### Statements of Income

(Continued)

For the Years Ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Net income (loss) before income taxes	\$ 221,612	\$ (126,008)
<b>Income Tax Provision (Benefit)</b>	<u>86,674</u>	<u>(223,315)</u>
Net income	<u>\$ 134,938</u>	<u>\$ 97,307</u>
<b>Earnings per Share, basic</b>	<u>\$ 0.22</u>	<u>\$ 0.16</u>
<b>Earnings per Share, diluted</b>	<u>\$ 0.22</u>	<u>\$ 0.16</u>
<b>Weighted Average Shares Outstanding, basic</b>	<u>610,175</u>	<u>609,011</u>
<b>Weighted Average Shares Outstanding, diluted</b>	<u>610,743</u>	<u>615,150</u>

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**

**Statements of Changes in Shareholders' Equity**

For the Years Ended December 31, 2008 and 2007

	<b>Common Stock</b>	<b>Capital Surplus</b>	<b>Retained (Deficit)</b>	<b>Accumulated Other Compre- hensive Income (Loss)</b>	<b>Compre- hensive Income</b>	<b>Total</b>
<b>Balance at December 31, 2006</b>	\$ 3,038,375	\$ 9,090,243	\$ (821,595)	\$ (280,286)		\$ 11,026,737
Comprehensive income:						
Net income	--	--	97,307	--	\$ 97,307	97,307
Other comprehensive income:						
Change in unrealized gain on securities available for sale (net of tax \$87,529)	--	--	--	--	239,250	--
Reclassification adjustment (net of tax \$685)	--	--	--	--	(1,331)	--
Change in pension liability (net of tax \$61,538)	--	--	--	--	91,490	--
Other comprehensive income	--	--	--	329,409	329,409	329,409
Total comprehensive income	--	--	--	--	<u>\$ 426,716</u>	--
Exercise of stock options	<u>12,500</u>	<u>40,000</u>	--	--		<u>52,500</u>
<b>Balance at December 31, 2007</b>	<b>\$ 3,050,875</b>	<b>\$ 9,130,243</b>	<b>\$ (724,288)</b>	<b>\$ 49,123</b>		<b>\$ 11,505,953</b>
Comprehensive income:						
Net income	--	--	134,938	--	\$ 134,938	134,938
Other comprehensive income:						
Change in unrealized gain on securities available for sale (net of tax \$188,097)	--	--	--	--	365,130	--
Reclassification adjustment (net of tax \$70,316)	--	--	--	--	(136,497)	--
Change in pension liability (net of tax \$15,430)	--	--	--	--	29,952	--
Other comprehensive income	--	--	--	258,585	258,585	258,585
Total comprehensive income	--	--	--	--	<u>\$ 393,523</u>	--
Stock-based compensation	--	<u>2,295</u>	--	--		<u>2,295</u>
<b>Balance at December 31, 2008</b>	<b><u>\$ 3,050,875</u></b>	<b><u>\$ 9,132,538</u></b>	<b><u>\$ (589,350)</u></b>	<b><u>\$ 307,708</u></b>		<b><u>\$ 11,901,771</u></b>

See Accompanying Notes to Financial Statements.

## COLONIAL VIRGINIA BANK

### Statements of Cash Flows

For the Years Ended December 31, 2008 and 2007

<b>Cash Flows From Operating Activities</b>	<u>2008</u>	<u>2007</u>
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$ 134,938	\$ 97,307
Net amortization (accretion) on investment securities	(13,517)	(91,823)
Deferred income tax benefit	(17,369)	(223,315)
Depreciation and amortization	255,424	264,581
Contribution of land	--	303,089
Provision for loan losses	239,200	190,700
Stock based compensation	2,295	--
(Gain) on securities	(206,813)	(2,016)
Changes in assets and liabilities:		
Decrease (increase) in accrued interest and other assets	207,255	(190,131)
Increase in accrued expenses and other liabilities	<u>121,102</u>	<u>285,540</u>
Net cash provided by operating activities	<u>\$ 722,515</u>	<u>\$ 633,932</u>
 <b>Cash Flows From Investing Activities</b>		
Purchases of securities available for sale	\$ (21,007,972)	\$ (17,910,702)
Principal paydowns of securities	4,497,690	2,218,432
Proceeds from calls and maturities of securities available for sale	9,755,741	7,302,595
Proceeds from sales of securities available for sale	8,079,509	--
Purchase of securities held to maturity	--	(1,009,100)
Proceeds from calls and maturities of securities held to maturity	2,347,858	1,506,031
(Purchase) of Federal Reserve Bank stock	--	(21,550)
(Purchase) of Federal Home Loan Bank stock	(506,300)	(160,600)
Net (increase) in loans	(8,700,821)	(7,723,782)
Increase in bank owned life insurance	(528,800)	(539,943)
Purchases of premises and equipment	<u>(489,144)</u>	<u>(62,662)</u>
Net cash (used in) investing activities	<u>\$ (6,552,239)</u>	<u>\$ (16,401,281)</u>
 <b>Cash Flows From Financing Activities</b>		
Net increase (decrease) in demand, savings, interest-bearing checking and money market deposits	\$ 4,056,980	\$ (888,716)
Net increase (decrease) in time deposits	(216,717)	14,426,488
Net increase in other borrowings	11,000,000	--
Proceeds from exercise of stock options	<u>--</u>	<u>52,500</u>
Net cash provided by financing activities	<u>\$ 14,840,263</u>	<u>\$ 13,590,272</u>
Net increase (decrease) in cash and cash equivalents	\$ 9,010,539	\$ (2,177,077)
 <b>Cash and Cash Equivalents</b>		
Beginning	<u>4,930,971</u>	<u>7,108,048</u>
Ending	<u>\$ 13,941,510</u>	<u>\$ 4,930,971</u>

## COLONIAL VIRGINIA BANK

### Statements of Cash Flows (continued)

For the Years Ended December 31, 2008 and 2007

#### Supplemental Disclosure of Cash Flow Information

Cash paid for interest	<u>\$ 3,299,394</u>	<u>\$ 3,054,910</u>
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#### Supplemental Disclosure of Noncash Activities

Unrealized gain on securities available for sale	<u>\$ 346,414</u>	<u>\$ 324,763</u>
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Change in pension liability	<u>\$ 45,382</u>	<u>\$ 153,028</u>
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See Accompanying Notes to Financial Statements.

# COLONIAL VIRGINIA BANK

## Notes to Financial Statements

### Note 1. Summary of Significant Accounting Policies

#### Significant Accounting Policies

The accounting and reporting policies of Colonial Virginia Bank (the “Bank”) are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. The more significant of these policies are summarized below.

#### Cash and Cash Equivalents

For purposes of the statements of cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing balances with banks and federal funds sold. Generally, federal funds are purchased and sold for one day periods.

#### Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Other restricted securities, such as Federal Reserve Bank and Federal Home Loan Bank stock, are carried at cost.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

#### Loans

The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by commercial loans throughout the Middle Peninsula area of Virginia. The ability of the Bank’s debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination and commitment fees and certain direct costs are deferred and the net amount is

## **Notes to Financial Statements**

amortized as an adjustment of the related loan's yield. The Bank is amortizing these amounts over the loan's contractual life.

The accrual of interest on mortgage, commercial and consumer loans is discontinued at the time the loan becomes 90 days delinquent unless the credit is well-secured and in process of collection. Non-performing loans are placed either in nonaccrual status pending further collection efforts or charged off if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on loans in nonaccrual status is accounted for on the cash basis or cost recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### **Allowance for Loan Losses**

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The Bank maintains 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 that the systems are maintained in accordance with accounting principles generally accepted in the United States of America; the accounting policies for loan charge-offs and recoveries; the assessment and measurement of impairment in the loan portfolio; and the loan grading system. The Bank uses an internal risk rating system and assigns a numeric rating to each loan based on multiple criteria, including but not limited to a borrower's credit history (evidenced by credit bureau reporting), collateral and its supporting value, type of work or industry in which the borrower is involved, and any noted exceptions to internal policy. Varying percentages of outstanding balances by risk rating are used in determining the adequacy of the allowance. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

## **Notes to Financial Statements**

Large groups of smaller balance, homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures. Impairments are charged to the allowance.

### **Premises and Equipment**

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the assets' estimated useful lives. Estimated useful lives range from 10 to 39 years for buildings and 3 to 7 years for furniture, fixtures and equipment.

### **Foreclosed Properties and Repossessed Assets**

Assets acquired through, or in lieu of, loan foreclosure are held for sale. They are initially recorded at the lower of the Bank's cost or the assets' fair market value at the date of foreclosure, less estimated selling costs thus establishing a new cost basis. Subsequent to foreclosure, valuations of the assets are periodically performed by management. Adjustments are made to the lower of the carrying amount or fair market value of the assets less selling costs. Revenue and expenses from operations and valuation changes are included in net expenses from repossessed assets. Repossessed assets totaled \$55,000 at December 31, 2007. The Bank had no foreclosed properties or repossessed assets at December 31, 2008.

### **Use of Estimates**

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of foreclosed real estate and the valuation allowance of deferred tax assets.

### **Income Taxes**

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating loss carry forwards, and tax credit carry forwards. Deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-

## **Notes to Financial Statements**

likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the statement of income.

### **Advertising Costs**

The Bank follows the policy of charging the production costs of advertising to expense as incurred. The Bank expensed \$125,402 and \$137,023 for advertising costs for the years ended December 31, 2008 and 2007, respectively.

### **Comprehensive Income**

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and minimum pension liability adjustments, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

### **Earnings Per Share**

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Bank relate solely to outstanding stock options, and are determined using the treasury stock method.

### **Stock-Based Compensation**

Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment", (SFAS 123(R)) requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS 123(R) covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The Bank measures the cost of employee services received in exchange for stock options based on the grant-date fair value of the award and recognizes the cost over the period the employee is required to provide services for the award. SFAS 123(R) permits entities to use any option-pricing model that meets the fair value objective in the Statement.

### **Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ("FASB") reached a consensus on Emerging Issues Task Force ("EITF") Issue 06-4, "Accounting for Deferred Compensation and

## Notes to Financial Statements

Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements,” (“EITF Issue 06-4”). In March 2007, the FASB reached a consensus on EITF Issue 06-10, “Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements,” (“EITF Issue 06-10”). Both of these standards require a company to recognize an obligation over an employee’s service period based upon the substantive agreement with the employee such as the promise to maintain a life insurance policy or provide a death benefit postretirement. The Bank adopted the provisions of these standards effective January 1, 2008. The adoption of these standards was not material to the financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The FASB has approved a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The Bank adopted SFAS 157 effective January 1, 2008. The adoption of SFAS 157 was not material to the financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement 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. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007, with early adoption available in certain circumstances. The Bank adopted SFAS 159 effective January 1, 2008. The Bank decided not to report any existing financial assets or liabilities at fair value that are not already reported, thus the adoption of this statement did not have a material impact on the financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), “Business Combinations” (“SFAS 141(R)”). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity’s first year that begins after December 15, 2008. The Bank does not expect the implementation of SFAS 141(R) to have a material impact on its financial statements, at this time.

## Notes to Financial Statements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51” (“SFAS 160”). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity’s first fiscal year that begins after December 15, 2008, with early adoption prohibited. The Bank does not expect the implementation of SFAS 160 to have a material impact on its financial statements, at this time.

In December 2007, the SEC issued Staff Accounting Bulletin No. 110, “Use of a Simplified Method in Developing Expected Term of Share Options” (“SAB 110”). SAB 110 expresses the current view of the staff that it will accept a company’s election to use the simplified method discussed in SAB 107 for estimating the expected term of “plain vanilla” share options regardless of whether the company has sufficient information to make more refined estimates. The staff noted that it understands that detailed information about employee exercise patterns may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. Implementation of SAB 110 did not have a material impact on the Bank’s financial statements.

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles,” (“SFAS 162”). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles. SFAS 162 is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.” Management does not expect the adoption of the provision of SFAS 162 to have any impact on the financial statements.

In October 2008, the FASB issued FSP FAS 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active,” (“FSP 157-3”). FSP 157-3 clarifies the application of SFAS No. 157 in determining the fair value of a financial asset during periods of inactive markets. FSP 157-3 was effective as of September 30, 2008 and did not have material impact on the Bank’s financial statements.

In January 2009, the FASB reached a consensus on EITF Issue 99-20-1. This FSP amends the impairment guidance in EITF Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,” to achieve more consistent determination of whether an other-than-temporary impairment has occurred. The FSP also retains and emphasizes the objective of an other-than-temporary impairment assessment and the related disclosure requirements in SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” and other related guidance. The FSP is effective for interim and annual reporting periods ending after December 15, 2008 and shall be applied prospectively. The FSP was effective as of December 31, 2008 and did not have a material impact on the financial statements.

## Notes to Financial Statements

### Note 2. Securities

Amortized cost and fair values of securities available for sale at December 31, 2008, were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Value</u>
Securities of U.S. government and federal agencies	\$ 4,000,011	\$ 64,771	\$ (12,141)	\$ 4,052,641
Mortgage-backed securities	20,628,698	564,117	(17,735)	21,175,080
Securities of states and political subdivisions	98,763	2,824	--	101,587
Restricted stock	<u>1,017,850</u>	<u>--</u>	<u>--</u>	<u>1,017,850</u>
Total	<u>\$ 25,745,322</u>	<u>\$ 631,712</u>	<u>\$ (29,876)</u>	<u>\$ 26,347,158</u>

Amortized cost and fair values of securities available for sale at December 31, 2007, were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Value</u>
Securities of U.S. government and federal agencies	\$ 12,161,125	\$ 160,930	\$ (5,071)	\$ 12,316,984
Mortgage-backed securities	13,256,816	115,703	(16,416)	13,356,103
Securities of states and political subdivisions	348,492	845	(567)	348,770
Restricted stock	<u>511,550</u>	<u>--</u>	<u>--</u>	<u>511,550</u>
Total	<u>\$ 26,277,983</u>	<u>\$ 277,478</u>	<u>\$ (22,054)</u>	<u>\$ 26,533,407</u>

## Notes to Financial Statements

Amortized cost and fair values of securities held to maturity at December 31, 2008, were as follows:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized (Losses)</b>	<b>Fair Value</b>
Securities of U.S. government and federal agencies	\$ 299,862	\$ 2,259	\$ --	\$ 302,121
Mortgage-backed securities	490,511	14,657	--	505,168
Total	\$ 790,373	\$ 16,916	\$ --	\$ 807,289

Amortized cost and fair values of securities held to maturity at December 31, 2007, were as follows:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized (Losses)</b>	<b>Fair Value</b>
Securities of U.S. government and federal agencies	\$ 2,633,471	\$ 24,901	\$ --	\$ 2,658,372
Mortgage-backed securities	570,435	--	(1,293)	569,142
Total	\$ 3,203,906	\$ 24,901	\$ (1,293)	\$ 3,227,514

Securities pledged to secure deposits of the Commonwealth of Virginia totaled approximately \$1,605,000 and \$1,100,000 at December 31, 2008 and 2007, respectively. Securities pledged to secure advances at the Federal Home Loan Bank totaled approximately \$12,750,044 and \$0 at December 31, 2008 and 2007, respectively.

The amortized cost and fair value of securities available for sale and held to maturity at December 31, 2008, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations without penalties.

## Notes to Financial Statements

	Available for Sale		Held to Maturity	
	Amortized	Fair	Amortized	Fair
	Cost	Value	Cost	Value
One to five years	\$ 1,719,034	\$ 1,761,567	\$ 299,862	\$ 302,121
Five to ten years	5,649,379	5,806,805	--	--
After ten years	17,359,059	17,760,936	490,511	505,168
Restricted stock	1,017,850	1,017,850	--	--
Total	<u>\$ 25,745,322</u>	<u>\$ 26,347,158</u>	<u>\$ 790,373</u>	<u>\$ 807,289</u>

For the years ended December 31, 2008 and 2007, proceeds from sales and calls of securities available for sale totaled \$15,254,591 and \$2,422,277, respectively. Gross realized gains of \$191,559 and \$1,439 and gross realized losses of \$297 and \$534 were recognized on those calls, respectively.

For the years ended December 31, 2008 and 2007, proceeds from calls of securities held to maturity totaled \$2,347,858 and \$1,056,031, respectively. Gross realized gains of \$15,551 and \$1,111 and there were no gross realized losses on those calls, respectively.

At December 31, 2008, nine investment securities had an unrealized loss of \$29,876 and a market value of \$2,985,312. The investment securities are obligations of entities that are excellent credit risks. The temporary impairment noted is the result of market conditions and does not reflect on the ability of the issuers to repay the obligations. There were no investment securities held at December 31, 2008 that had been in an unrealized loss position for greater than 12 months. The Bank has the intent and the ability to hold these securities until such time as there is a recovery of the unrealized loss or until maturity.

2008 Description of Securities	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
Securities of U.S. government and federal agencies	\$1,982,500	(\$12,141)	\$ --	\$ --	\$1,982,500	(\$12,141)
Mortgage-backed securities	1,002,812	(17,735)	--	--	1,002,812	(17,735)
Total temporarily						
Impaired securities	<u>\$2,985,312</u>	<u>(\$29,876)</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$2,985,312</u>	<u>(\$29,876)</u>

## Notes to Financial Statements

2007 <u>Description of Securities</u>	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>
Securities of U.S. government and federal agencies	\$999,800	(\$71)	\$1,245,000	(\$5,000)	\$2,244,800	(\$5,071)
Mortgage-backed Securities	2,435,339	(5,937)	1,307,855	(11,772)	3,743,194	(17,709)
Securities of states and political subdivisions	97,925	(567)	--	--	97,925	(567)
Total temporarily impaired securities	<u>\$3,533,064</u>	<u>(\$6,575)</u>	<u>\$2,552,855</u>	<u>(\$16,772)</u>	<u>\$6,085,919</u>	<u>(\$23,347)</u>

### Note 3. Loans

The loan portfolio was composed of the following at the dates indicated:

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Mortgage:		
Construction and land development	\$ 15,071,017	\$ 13,481,473
Residential real estate	18,387,347	15,032,853
Nonresidential	12,119,703	9,227,496
Commercial	11,187,153	11,580,579
Agricultural and other farm loans	519,802	545,586
Consumer and all other loans	5,579,933	4,407,673
	<u>\$ 62,864,955</u>	<u>\$ 54,275,660</u>
Allowance for loan losses	622,068	491,383
Unearned income	122,762	125,773
Loans, net	<u>\$ 62,120,125</u>	<u>\$ 53,658,504</u>

Overdrafts totaling \$31,744 and \$14,767 at December 31, 2008 and 2007, respectively, were reclassified from deposits to loans.

## Notes to Financial Statements

The following is a summary of information pertaining to impaired and non-accrual loans:

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<i>(in thousands)</i>	
Impaired loans without a valuation allowance	\$ 75	\$ 1,052
Impaired loans with a valuation allowance	281	-
Total impaired loans	<u>\$ 356</u>	<u>\$ 1,052</u>
Valuation allowance related to impaired loans	<u>\$ 75</u>	<u>\$ -</u>
Non-accrual loans excluded from impaired loans	<u>\$ 6</u>	<u>\$ 8</u>
Total loans past due ninety days or more and still accruing	<u>\$ 91</u>	<u>\$ -</u>

	<b>Years Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<i>(in thousands)</i>	
Average investment in impaired loans	<u>\$ 704</u>	<u>\$ 1,085</u>
Interest income recognized on impaired loans	<u>\$ 24</u>	<u>\$ 107</u>
Interest income recognized on a cash basis on impaired loans	<u>\$ 24</u>	<u>\$ 107</u>

No additional funds are committed to be advanced in connection with impaired loans.

An analysis of the allowance for loan losses was as follows for the periods indicated:

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
Balance at the beginning of the period	\$ 491,383	\$ 329,462
Provision for loan losses	239,200	190,700
Loans charged off	(111,978)	(31,621)
Recoveries on loans previously charged off	<u>3,463</u>	<u>2,842</u>
Balance at the end of the period	<u>\$ 622,068</u>	<u>\$ 491,383</u>

## Notes to Financial Statements

### Note 4. Premises and Equipment

A summary of the cost and accumulated depreciation of premises and equipment follows:

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
Bank building and improvements	\$ 2,072,511	\$ 2,072,511
Land and land improvements	1,442,676	1,431,722
Furniture, fixtures and equipment	1,252,714	1,201,635
Construction in progress	452,608	25,496
	<u>\$ 5,220,509</u>	<u>\$ 4,731,364</u>
Less accumulated depreciation	1,233,045	977,620
	<u>\$ 3,987,464</u>	<u>\$ 3,753,744</u>

Depreciation expense for the years ended December 31, 2008 and 2007 totaled \$255,424 and \$264,581, respectively.

As of December 31, 2008, the Bank had no lease agreements.

### Note 5. Borrowings

The Bank had \$11,000,000 in fixed-rate Federal Home Loan Bank borrowings at December 31, 2008. The weighted-average interest rate on the borrowings was 1.74% at December 31, 2008, with rates ranging from 0.81% to 2.67%. The advances mature as follows: 2009, \$4,500,000; 2010, \$4,500,000; and 2011, \$2,000,000. See Note 2 for information on securities pledged as collateral for these borrowings.

The Bank has unsecured lines of credit with correspondent banks totaling \$7,100,000 available for overnight borrowing. No balances were outstanding on these lines at December 31, 2008 or 2007.

### Note 6. Related Party Transactions

In the normal course of business, the Bank extends credit to directors and executive officers. The aggregate amount of outstanding loans at December 31, 2008 and 2007 totaled \$2,305,264 and \$1,980,442, respectively. During the year ended December 31, 2008, total principal additions were \$1,538,758 and total principal repayments were \$1,213,936.

Deposits from related parties totaled \$7,209,285 and \$5,199,474 at December 31, 2008 and 2007, respectively.

### Note 7. Time Deposits

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2008 and 2007 was \$26,800,243 and \$23,807,990, respectively.

## Notes to Financial Statements

At December 31, 2008, the scheduled maturities on certificates of deposit are as follows:

2009	\$ 54,136,784
2010	7,910,492
2011	234,973
2012	176,078
2013	<u>117,130</u>
	<u>\$ 62,575,457</u>

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2008 and 2007, brokered deposits totaled \$6,145,000 and \$2,000,000, respectively, and were included in time deposits on the Bank's balance sheets.

### Note 8. Income Taxes

The Bank files income tax returns in the U.S. federal jurisdiction and the state of Virginia. With few exceptions, the Bank is no longer subject to U.S. federal and state income tax examinations by tax authorities for years prior to 2005.

The Bank adopted the provision of FIN 48, "Accounting for Uncertainty in Income Taxes", on January 1, 2007 with no impact on the financial statements.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2008 and 2007 are presented below:

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Deferred Tax Assets:</b>		
Net operating loss carry forward	\$ --	\$ 48,700
Allowance for loan losses	191,517	150,756
Organizational and start-up expenses	--	24,891
Deferred compensation	208,158	136,460
SFAS 158 pension adjustment	61,538	61,538
Contributions carryover	<u>84,483</u>	<u>114,238</u>
	<u>\$ 545,696</u>	<u>\$ 536,583</u>
<b>Deferred Tax Liabilities:</b>		
Bank premises and equipment	37,466	45,722
Unrealized gains on securities	<u>204,624</u>	<u>86,844</u>
	<u>\$ 242,090</u>	<u>\$ 132,566</u>
Net Deferred Tax Assets	<u>\$ 303,606</u>	<u>\$ 404,017</u>

## Notes to Financial Statements

The provision for income taxes charged to operations for the years ended December 31, 2008 and 2007:

	<b>2008</b>	<b>2007</b>
Current tax expense	\$ 104,043	\$ --
Deferred tax (benefit)	(17,369)	(56,422)
Change in valuation allowance	--	(166,893)
Income tax provision (benefit)	\$ 86,674	\$ (223,315)

The reasons for the differences between income tax expense and the amount computed by applying the statutory federal income tax rate are as follows:

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
Income taxes computed at the applicable federal income tax rate	\$ 75,348	\$ (42,843)
Increase (decrease) resulting from		
Tax exempt income from life insurance	(9,792)	(13,579)
Gain on redemption of life insurance	21,593	--
Adjustment for recognition of deferred asset	--	(166,893)
Other	(475)	--
	\$ 86,674	\$ (223,315)

Contribution carry forwards totaling approximately \$248,480 expire December 31, 2012.

### **Note 9. Financial Instruments with Off-Balance-Sheet Risk**

The Bank is party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.

The Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

## Notes to Financial Statements

The following financial instruments were outstanding whose contract amounts represent credit risk:

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
	(in thousands)	
Commitments to grant loans	\$ 1,031	\$ 1,538
Unfunded commitments under lines of credit	12,225	14,012
Commercial and standby letters of credit	356	309

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. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments, if deemed necessary.

The Bank maintains its cash accounts in several correspondent banks. The amount by which cash on deposit in those banks exceeds the federally insured limits totaled \$9,259,304 and \$401,621 at December 31, 2008 and 2007, respectively.

### **Note 10. Stock Option Plan**

During 2004, the Bank adopted an incentive stock plan under which options may be granted to certain key employees and directors for purchase of the Bank's common stock. The effective date of the plan was June 16, 2004, with an expiration date of June 16, 2014. The plan reserves for issuance 75,000 shares of the Bank's voting common stock. At December 31, 2008, 35,396 shares remained available for granting under the plan. The stock option plan requires that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant. Such options are generally not exercisable until one year from the date of issuance. The options will expire in no more than ten years after the date of grant. Compensation expense recognized in 2008 totaled \$2,295. Remaining compensation expense to be recognized on non-vested options was \$6,887 at December 31, 2008 and will be recognized during 2009.

## Notes to Financial Statements

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	<b>2008</b>
Dividend yield	0.0%
Expected life	5.5 years
Expected volatility	22.5%
Risk-free interest rate	3.01%

The expected volatility is based on historical volatility of peer institutions. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on the average of the contractual life and vesting schedule for the option. The dividend yield assumption is based on the Bank's history and expectation of dividend payouts.

A summary of the status of the Bank's stock option plan is presented below:

	<b>2008</b>			<b>2007</b>	
	<b>Shares</b>	<b>Average Exercise Price</b>	<b>Aggregate Intrinsic Value (1)</b>	<b>Shares</b>	<b>Average Exercise Price</b>
Outstanding at beginning of year	32,354	\$ 21.30		37,354	\$ 21.26
Granted	2,350	14.10		--	
Exercised	--	--		(2,500)	21.00
Expired/forfeited	(100)	22.00		(2,500)	21.00
Outstanding at end of year	34,604	\$ 20.81	\$ 4,465	32,354	\$ 21.30
Options exercisable, end of year	32,254	\$ 21.30	\$ --	32,354	\$ 21.30
Weighted average fair value of options granted during the year	\$ 3.91			\$ --	

(1)The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2008. This amount changes based on changes in the market value of the Bank's stock.

## Notes to Financial Statements

Information pertaining to options outstanding at December 31, 2008 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$21.00 - \$22.00	32,254	5.96 years	\$ 21.30	32,254	\$ 21.30
\$14.10	2,350	9.75 years	\$ 14.10	--	--

### Note 11. Employee Benefits

In October 2004, the Bank implemented a Supplemental Executive Retirement Plan (“SERP”) in order to attract future executives and retain current executives as well as to provide additional deferred compensation benefits for such employees. Currently, these benefits are available only to the Bank’s Chief Executive Officer and Chief Financial Officer. Under the SERP plan, each of the executive officers is entitled to receive retirement benefits in an amount that is based on a fixed percentage of their final three year average of total salary including bonuses, if any, depending on their age at retirement (giving effect to certain present value calculations and salary increase assumptions). Given the executives remain at the Bank until they reach age 65, they will be entitled to receive the maximum benefit of 55% of their final three years’ average salary. These benefits become payable upon the officer’s retirement and will be paid to the individual over a period of 15 years commencing with the first year following the retirement. Because the SERP plan also provides death benefits, no retirement benefits are paid following the death of the executive.

The Bank records periodic accruals for the cost of providing such benefits by charges to income. The amount expensed is impacted by actuarial assumptions including an annual discount rate of 6.00% and an assumed annual salary increase of 3.00%. The Bank expensed \$215,367 and \$210,060 during the years ended December 31, 2008 and 2007, respectively, for the SERP plan. In addition, the Bank implemented SFAS No. 158 during 2006, which required an initial implementation adjustment of \$210,946 recorded as a reduction in accumulated other comprehensive income. This amount will be amortized into expense over the period in which the two covered executive officers reach full retirement age of 65. Amortization included in expense in 2008 and 2007 totaled \$29,952. Total SERP expense including amortization of the implementation adjustment expected for 2009 is \$210,876.

In order to fund the SERP plan, the Bank purchased life insurance policies aggregating \$6.5 million on the lives of the executives included in the SERP plan. The Bank is the owner and beneficiary of these policies. The policies had an aggregate cash surrender value to the Bank of \$2,618,333 and \$2,089,533 at December 31, 2008 and 2007, respectively, which is reflected in other assets on the Bank’s Balance Sheets.

## Notes to Financial Statements

	<b>2008</b>	<b>2007</b>
<b>Change in Benefit Obligation</b>		
Projected Benefit Obligation, Beginning of the Year	\$ 582,348	\$ 402,240
Service cost	144,750	150,359
Interest cost	40,665	29,749
Projected Benefit Obligation, End of the Year	<u>\$ 767,763</u>	<u>\$ 582,348</u>
<b>Amounts Recognized in the Balance Sheet</b>		
Other liabilities, accrued SERP liability	<u>\$ 767,763</u>	<u>\$ 582,348</u>
<b>Amounts Recognized in Accumulated Other Comprehensive Loss (Income)</b>		
Accrued SERP liability	\$ 151,042	\$ 180,994
Deferred income tax benefit	(61,538)	(61,538)
	<u>\$ 89,504</u>	<u>\$ 119,456</u>
<b>Components of Net Periodic Benefit Cost</b>		
Service cost	\$ 144,750	\$ 150,359
Interest cost	40,665	29,749
Amortization of prior service cost	29,952	29,952
Net Periodic Benefit Cost	<u>\$ 215,367</u>	<u>\$ 210,060</u>
<b>Other Changes in Benefit Obligations Recognized in Other Comprehensive Loss (Income)</b>		
Amortization of prior service cost	\$ (29,952)	\$ (29,952)
<b>Total Recognized in Net Periodic Benefit Cost and Other Comprehensive Loss (Income)</b>		
	<u>\$ 185,415</u>	<u>\$ 180,108</u>

The following benefit payments reflecting the appropriate expected future service are expected to be paid:

<b><u>Pension Benefits</u></b>	
(in thousands)	
2011	\$ 46
2012	92
2013 – 2017	497

### **401(k) Plan**

The Bank currently has a 401(k) defined contribution plan applicable to all eligible employees. Currently, the Bank does not make contributions to the Plan, but may in the future based on the discretion of the Board of Directors. Employees may elect to contribute to the Plan an amount up to 100% of their salary, not to exceed the maximum contribution allowed by the Internal Revenue Service. There is no Bank common stock included in the 401(k) Plan assets.

## Notes to Financial Statements

### Note 12. Regulatory Requirements

Under regulatory guidelines, the Bank may pay dividends only out of its retained earnings. However, regulatory authorities may limit the payment of dividends by any bank when it is determined that such a limitation is necessary to ensure financial soundness. At December 31, 2008, there are no retained earnings available from which to pay dividends.

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

Quantitative measures established by regulation to ensure capital adequacy require financial institutions 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 (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2008, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Bank's actual capital amounts and ratios as of December 31, 2008 and 2007 are also presented in the table.

## Notes to Financial Statements

	<u>Actual</u>		<u>Minimum Capital Requirement</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	(Amounts in Thousands)					
As of December 31, 2008:						
Total Capital (to Risk Weighted Assets)	\$ 12,061	16.10%	\$ 5,992	8.00%	\$ 7,490	10.00%
Tier 1 Capital (to Risk Weighted Assets)	\$ 11,594	15.48%	\$ 2,996	4.00%	\$ 4,494	6.00%
Tier 1 Capital (to Average Assets)	\$ 11,594	10.94%	\$ 4,240	4.00%	\$ 5,301	5.00%
As of December 31, 2007:						
Total Capital (to Risk Weighted Assets)	\$ 11,948	18.26%	\$ 5,235	8.00%	\$ 6,544	10.00%
Tier 1 Capital (to Risk Weighted Assets)	\$ 11,457	17.51%	\$ 2,618	4.00%	\$ 3,926	6.00%
Tier 1 Capital (to Average Assets)	\$ 11,457	12.13%	\$ 3,778	4.00%	\$ 4,722	5.00%

### Note 13. Fair Value Measurements

The Bank adopted SFAS No. 157, "Fair Value Measurements" (SFAS 157), on January 1, 2008 to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. SFAS 157 clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

In February of 2008, the FASB issued Staff Position No. 157-2 (FSP 157-2) which delayed the effective date of SFAS 157 for certain nonfinancial assets and nonfinancial liabilities except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP 157-2 defers the effective date of SFAS 157 for such nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Thus, the Bank has only partially applied SFAS 157.

In October of 2008, the FASB issued Staff Position No. 157-3 (FSP 157-3) to clarify the application of SFAS 157 in a market that is not active and to provide key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 was effective upon issuance, including prior periods for which financials statements were not issued.

SFAS 157 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Bank's

## Notes to Financial Statements

market assumptions. The three levels of the fair value hierarchy under SFAS 157 based on these two types of inputs are as follows:

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

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

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

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

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2). Restricted stock is carried at cost based on the redemption provision of the Federal Reserve Bank and Federal Home Loan Bank and is therefore excluded from the following table.

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008:

Description	Balance as of December 31, 2008	<b>Fair Value Measurements at December 31, 2008</b>		
		<b>Using</b>		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available-for-sale securities	\$25,329,308	\$ --	\$25,329,308	\$ --

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

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

Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with

## Notes to Financial Statements

impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Income. At December 31, 2008, the Bank had \$75,000 in impaired loans that was fully reserved by a valuation allowance. The fair value of these loans was based on Level 3 inputs.

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

*Cash, short-term investments and federal funds sold:* The carrying amounts of cash and short-term instruments approximate fair values. The carrying amounts of interest-bearing deposits maturing within 90 days approximate their fair values.

*Securities:* Fair values for securities, excluding restricted stock, are based on quoted market prices. The carrying value of restricted stock approximates fair value based on the redemption provisions of the respective entity.

*Loans:* For certain homogeneous categories of loans, such as some residential mortgages, and other consumer loans, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of other types of loans is estimated by discounting the future cash flows 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 demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

*Accrued interest:* The carrying amounts of accrued interest approximate fair value.

*Off-balance-sheet instruments:* Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. 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 standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties.

## Notes to Financial Statements

at the reporting date. At December 31, 2008 and 2007, the fair value of loan commitments and standby letters of credit were immaterial.

The estimated fair values and related carrying amounts of the Bank's financial instruments are as follows:

	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)		(In Thousands)	
Financial Assets:				
Cash and short-term investments	\$13,942	\$13,942	\$4,931	\$4,931
Securities	27,138	27,154	29,737	29,761
Loans, net	62,120	62,684	53,659	53,943
Accrued interest receivable	421	421	537	537
Financial Liabilities:				
Deposits	\$86,789	\$87,037	\$82,949	\$83,070
FHLB advances and other debt	11,000	11,134	--	--
Accrued interest payable	233	233	365	365

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Bank's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

### Note 14. Earnings Per Share

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

	2008		2007	
	<u>Shares</u>	<u>Per Share Amount</u>	<u>Shares</u>	<u>Per Share Amount</u>
Basic earnings per share	610,175	<u>\$ 0.22</u>	609,011	<u>\$ 0.16</u>
Effect of dilutive securities,				
Stock options	<u>568</u>		<u>6,139</u>	
Diluted earnings per share	<u>610,743</u>	<u>\$ 0.22</u>	<u>615,150</u>	<u>\$ 0.16</u>

## **Notes to Financial Statements**

During the year ended December 31, 2008, options representing 24,165 shares on average were excluded from the calculation of diluted earnings per share because their impact would be anti-dilutive.

## BOARD OF DIRECTORS

### **Joseph A. Lombard, Jr., DDS**

Chairman of the Board  
Owner  
Lombard, Luckam, Smith & Gordon

### **Hal D. Bourque**

Retired Executive Vice President  
Virginia Health Services

### **Charles F. Dawson**

Retired Partner  
Bay Design Group, PC

### **William J. Farinholt**

President & CEO  
Colonial Virginia Bank

### **Joseph F. Fary**

Manager  
W. T. Fary Brothers Co., LLC

### **William D. Fary, Sr.**

President  
Bill Fary Ford, Inc.

### **Walter Boyd Hurley, Jr.**

Owner/Operator  
Bethpage Camp Resort  
Greys Point Camp

### **James L. Miller, Jr.**

Owner/President  
Jim Miller Construction, Inc.  
Miller's Septic Service, Inc.

### **Kenneth E. Smith**

Executive Vice President  
Chief Financial Officer  
Colonial Virginia Bank

### **Elsa C. Verbyla**

Managing Editor  
Gloucester-Mathews Gazette-Journal

### **David G. Walker, DDS**

Owner  
David G. Walker, DDS

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## OFFICERS & STAFF

### **EXECUTIVE OFFICERS**

#### **William J. Farinholt**

President  
Chief Executive Officer

#### **Kenneth E. Smith**

Executive Vice President  
Chief Financial Officer

### **OFFICERS**

#### **Donna Kay Akins**

Vice President  
Loan Officer

#### **Michelle D. Ammons**

Vice President  
Administrative Officer

#### **Connie S. Birdsall**

Vice President  
Area Operations Manager

#### **Cheryl S. Dame**

Vice President  
Business Development Officer

#### **G. Thomas Haskins, Jr.**

Investment Consultant

#### **G. Henry Haupt**

Vice President  
Loan Officer

#### **Kathleen C. Healy**

Vice President  
Accounting Officer

#### **Stephanie F. Hunt**

Vice President  
Loan Administration

#### **Jan Marshall**

BSA Officer  
Bookkeeping Manager

#### **Christopher P. Rowe**

Assistant Vice President  
IT Administrator

#### **Martha W. Soles**

Vice President  
Merchant/Credit Card Division

#### **Charles W. Sutton**

Assistant Vice President  
Loan Officer

#### **Randall W. Thorpe**

Credit Analyst & Review Officer

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#### **Branch Manager – York River**

**Shirley H. Snow**

#### **Customer Service Representatives**

**Kimberly W. Davis**  
**Bonnie P. Robbins**

#### **Head Tellers**

**Kathy H. Shackelford**  
**Stacy M. Hudgins**

#### **Tellers**

**Nicole L. Bercot**  
**Cynthia S. Dunn**  
**Amanda A. Ellis**  
**Polly A. Harrison**  
**Cartrina R. Jones**  
**Kimberly D. Milby**  
**Jeanne A. Trower**

#### **MORTGAGE DIVISION**

##### **Loan Officers**

**Barbara M. Smith**  
**Lucas P. Smith**

#### **RDC/IP Administrator**

**Bonnie S. Bunting**

#### **Senior Financial Analyst**

**Benjamin D. Farner**

#### **Special Projects**

**Mildred S. (Scottie) Shackelford**

## **GENERAL INFORMATION**

### **Corporate Headquarters**

6720 Sutton Road  
P. O. Box 2120  
Gloucester, VA 23061  
804-695-9300

### **Main Office**

6720 Sutton Road  
P. O. Box 2120  
Gloucester, VA 23061  
804-695-9300

### **York River Office**

1553 George Washington Mem. Hwy.  
P. O. Box 370  
Gloucester Point, VA 23062  
804-642-0178

## **ANNUAL MEETING**

The 2009 Annual Meeting of Shareholders will be held at 6:30 p.m. on May 12, 2009 at **The Settlement at Powhatan Creek, 4101 Monticello Avenue, Williamsburg, Virginia.**

## **FINANCIAL INFORMATION**

To obtain financial information on Colonial Virginia Bank, contact Kenneth E. Smith, Executive Vice President at the Main Office, 804-693-9300.

## **CORPORATE PUBLICATIONS**

Colonial Virginia Bank's Annual Report and Form 10-K, Quarterly Reports and other corporate publications are available on request by writing or calling Kenneth E. Smith, Executive Vice President at the Main Office, 804-695-9300. Corporate publications are also available at the Bank's website, [www.colonialvabank.com](http://www.colonialvabank.com), under Investor Relations.

## **SHAREHOLDER RELATIONS**

If you have questions about a specific stock ownership account, write or call Michelle D. Ammons at the Sutton Road Office. The Bank serves as the Company's transfer agent. Transfer information may be directed to Michelle D. Ammons at the Main Office, 804-695-9300.