

THE BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D.C. 20551

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d)  
of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2008

or

Transition Report pursuant to Section 13 or 15(d)  
of the Securities Exchange Act of 1934

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

COLONIAL VIRGINIA BANK

(Exact name of registrant as specified in its charter)

Virginia

(State or other jurisdiction of  
incorporation or organization)

75-3093106

(IRS Employer  
Identification No.)

6720 Sutton Road  
Gloucester, Virginia

(Address of principal executive offices)

23061

(Zip Code)

(804) 695-9300

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

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

610,175 shares of common stock, par value \$5.00 per share,  
outstanding as of August 14, 2008

# COLONIAL VIRGINIA BANK

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## PART I. FINANCIAL INFORMATION

### Item 1. FINANCIAL STATEMENTS

#### COLONIAL VIRGINIA BANK Balance Sheets

	(Unaudited) June 30, 2008	December 31, 2007
	<u>                    </u>	<u>                    </u>
<b>Assets:</b>		
Cash and due from banks	\$ 4,256,867	\$ 2,174,513
Federal funds sold	2,256,000	2,756,458
Securities available for sale, at fair market value	33,718,935	26,533,407
Securities held to maturity (fair market value of \$1,825,516 in 2008 and \$3,227,514 in 2007)	1,821,495	3,203,906
Loans, net of allowance for loan losses of \$523,653 in 2008 and \$491,383 in 2007	58,497,302	53,658,504
Bank premises and equipment, net	3,933,194	3,753,744
Bank owned life insurance	2,103,933	2,089,533
Other assets	<u>1,318,417</u>	<u>1,290,036</u>
 Total assets	 <u>\$ 107,906,143</u>	 <u>\$ 95,460,101</u>
 <b>Liabilities and Shareholders' Equity:</b>		
Liabilities:		
Deposits:		
Non-interest bearing demand deposits	\$ 8,886,068	\$ 6,779,679
Savings and interest bearing demand deposits	13,463,629	13,376,847
Time deposits	<u>65,107,644</u>	<u>62,792,174</u>
Total deposits	\$ 87,457,341	\$ 82,948,700
 Accrued expenses and other liabilities	 1,044,803	 1,005,448
FHLB advances	<u>8,000,000</u>	<u>-</u>
Total liabilities	<u>\$ 96,502,144</u>	<u>\$ 83,954,148</u>
 Shareholders' Equity:		
Preferred stock, par value \$5.00 per share, authorized 5,000,000 shares; no shares issued and outstanding	\$ -	\$ -
Common stock, par value \$5.00 per share, authorized 10,000,000 shares; issued and outstanding 610,175 shares	3,050,875	3,050,875
Capital surplus	9,130,243	9,130,243
Retained (deficit)	(657,332)	(724,288)
Accumulated other comprehensive income (loss), net	<u>(119,787)</u>	<u>49,123</u>
Total shareholders' equity	<u>\$ 11,403,999</u>	<u>\$ 11,505,953</u>
 Total liabilities and shareholders' equity	 <u>\$ 107,906,143</u>	 <u>\$ 95,460,101</u>

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Statements of Income**

	(Unaudited)		(Unaudited)	
	Three Months	Three Months	Six Months	Six Months
	Ended	Ended	Ended	Ended
	June 30,	June 30,	June 30,	June 30,
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
<b>Interest and Dividend Income</b>				
Interest and fees on loans	\$1,140,276	\$1,130,602	\$2,329,769	\$2,208,115
Interest on securities available for sale				
Taxable	439,373	274,520	804,488	526,379
Dividends	11,018	5,044	19,328	10,058
Interest on federal funds sold and other	33,507	127,364	85,644	234,587
Total interest income	<u>\$1,624,174</u>	<u>\$1,537,530</u>	<u>\$3,239,229</u>	<u>\$2,979,139</u>
<b>Interest Expense</b>				
Interest on deposits	\$808,698	\$767,587	\$1,683,581	\$1,467,881
Interest on short term borrowings	27,113	--	30,749	\$1,467,881
Total interest expense	<u>\$835,811</u>	<u>\$767,587</u>	<u>\$1,714,330</u>	<u>\$1,467,881</u>
Net interest income	\$788,363	\$769,943	\$1,524,899	\$1,511,258
<b>Provision for Loan Losses</b>	<u>21,050</u>	<u>8,550</u>	<u>42,100</u>	<u>14,600</u>
Net interest income after provision for loan losses	<u>\$767,313</u>	<u>\$761,393</u>	<u>\$1,482,799</u>	<u>\$1,496,658</u>
<b>Other Income</b>				
Service charges on deposit accounts	\$21,944	\$22,306	\$45,087	\$44,316
Net gain on securities	3,000	0	66,726	0
Other service charges, commissions and fees	45,807	43,298	113,522	78,821
Total other income	<u>\$70,751</u>	<u>\$65,604</u>	<u>\$225,335</u>	<u>\$123,137</u>
<b>Other Expense</b>				
Salaries and employee benefits	\$437,732	\$402,269	\$887,078	\$808,176
Occupancy expense	48,971	49,483	94,627	89,781
Furniture and equipment expense	21,944	15,699	42,053	31,158
Data processing	118,797	108,368	234,499	213,467
Advertising	30,424	34,055	64,518	78,094
Professional fees	45,717	27,264	81,285	46,833
Stationery and supplies	9,484	10,037	19,978	23,113
Postage and freight	9,211	9,581	17,042	19,275
Regulatory assessments	22,070	16,612	42,459	23,837
Insurance	7,491	9,521	16,642	19,112
Taxes	16,417	15,612	33,175	31,332
Other operating expenses	44,078	44,843	82,822	77,070
Total other expense	<u>\$812,336</u>	<u>\$743,344</u>	<u>\$1,616,178</u>	<u>\$1,461,248</u>
Net Income before income taxes	\$25,728	\$83,653	\$91,956	\$158,547
Income taxes	25,000	0	25,000	0
Net Income	<u>\$ 728</u>	<u>\$83,653</u>	<u>\$66,956</u>	<u>\$158,547</u>
Earnings per share, basic and diluted	\$0.00	\$0.14	\$0.11	\$0.26
Weighted Average Shares Outstanding, basic	610,175	607,977	610,175	607,827
Weighted Average Shares Outstanding, diluted	610,175	617,006	610,175	616,739

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Statements of Changes in Shareholders' Equity**  
**For the Six Months Ended June 30, 2008**  
**and June 30, 2007 (Unaudited)**

	<u>Common Stock</u>	<u>Capital Surplus</u>	<u>Retained (Deficit)</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Comprehensive Income</u>	<u>Total</u>
<b>Balance at December 31, 2006</b>	\$ 3,038,375	\$ 9,090,243	\$ (821,595)	\$ (280,286)		\$ 11,026,737
Comprehensive income:						
Net income	--	--	158,547	--	\$ 158,547	158,547
Other comprehensive loss,						
Change in unrealized loss on securities available for sale	--	--	--	--	(89,203)	
Change in pension liability	--	--	--	--	14,976	
Other comprehensive loss	--	--	--	(74,227)	\$ (74,227)	(74,227)
Total comprehensive income	--	--	--	--	\$ 84,320	
Exercise of stock options	12,500	40,000	--	--		52,500
<b>Balance at June 30, 2007</b>	<u>\$ 3,050,875</u>	<u>\$ 9,130,243</u>	<u>\$ (663,048)</u>	<u>\$ (354,513)</u>		<u>\$ 11,163,557</u>
<b>Balance at December 31, 2007</b>	\$ 3,050,875	\$ 9,130,243	\$ (724,288)	\$ 49,123		\$ 11,505,953
Comprehensive loss:						
Net income	--	--	66,956	--	\$ 66,956	66,956
Other comprehensive loss,						
change in unrealized loss on securities available for sale	--	--	--	--	(183,886)	
Change in pension liability	--	--	--	--	14,976	
Other comprehensive loss	--	--	--	(168,910)	\$ (168,910)	(168,910)
Total comprehensive loss	--	--	--	--	\$ (101,954)	
<b>Balance at June 30, 2008</b>	<u>\$ 3,050,875</u>	<u>\$ 9,130,243</u>	<u>\$ (657,332)</u>	<u>\$ (119,787)</u>		<u>\$ 11,403,999</u>

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Statements of Cash Flows**  
**For the Six Months Ended June 30, 2008**  
**and June 30, 2007 (Unaudited)**

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	2008	2007
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$ 66,956	\$ 158,547
Net (accretion) on investment securities	(11,224)	(50,372)
Depreciation and amortization	128,682	129,173
Provision for loan losses	42,100	14,600
Gain on securities	(66,726)	-
Changes in assets and liabilities:		
Decrease (increase) in accrued interest and other assets	41,349	(88,699)
Increase in accrued expenses and other liabilities	79,332	144,201
Net cash provided by operating activities	\$ 280,469	\$ 307,450
 <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of securities available for sale	\$ (17,333,806)	\$ (7,385,325)
Principal paydowns of securities	2,128,471	907,820
Proceeds from calls and maturities of securities available for sale	7,039,564	4,618,872
Proceeds from sales of securities available for sale	1,191,480	-
Purchase of securities held to maturity	-	(1,009,100)
Proceeds from calls and maturities of securities held to maturity	1,347,857	200,000
(Purchase) of Federal Reserve Stock	(6,050)	(10,750)
(Purchase) of Federal Home Loan Bank Stock	(371,300)	-
Net (increase) in loans	(4,880,898)	(2,971,576)
Increase in bank owned life insurance	(14,400)	(515,600)
Purchases of premises and equipment	(308,132)	(21,148)
Net cash (used in) investing activities	\$ (11,207,214)	\$ (6,186,807)
 <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in demand, savings, interest-bearing checking and money market deposits	\$ 2,193,171	\$ 981,772
Net increase in time deposits	2,315,470	6,767,252
Net increase in other borrowings	8,000,000	-
Proceeds from sale of stock	-	52,500
Net cash provided by financing activities	\$ 12,508,641	\$ 7,801,524
 Net increase in cash and cash equivalents	\$ 1,581,896	\$ 1,922,167
 <b>CASH AND CASH EQUIVALENTS</b>		
Beginning	\$ 4,930,971	\$ 7,108,048
Ending	\$ 6,512,867	\$ 9,030,215
 <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid for interest	\$ 1,789,284	\$ 1,442,381
 <b>SUPPLEMENTAL DISCLOSURE OF NONCASH ACTIVITIES</b>		
Unrealized (loss) on securities available for sale	(278,616)	(89,203)
Amortization of adjustment to initially apply SFAS No. 158	14,976	14,976

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Notes to Financial Statements**  
For the Six Months Ended June 30, 2008  
and June 30, 2007 (Unaudited)

**Note 1. General**

Colonial Virginia Bank (the Bank) was organized under the laws of the Commonwealth of Virginia to engage in a general banking business serving the community in and around Gloucester County, Virginia. The Bank is a member of the Federal Reserve System and the Federal Deposit Insurance Corporation. It is subject to the regulations of the Federal Reserve System and the State Corporation Commission of Virginia. Consequently, it undergoes periodic examinations by these regulatory authorities.

In the opinion of management, the accompanying unaudited financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the Bank's financial position at June 30, 2008, the statements of income for the three and six months ended June 30, 2008, and the changes in shareholders' equity and cash flows for the six months ended June 30, 2008. Financial statements are prepared in accordance with generally accepted accounting principles. Operating results for the six month period ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. The statements should be read in conjunction with the Notes to Financial Statements included in the Bank's Annual Report on Form 10-KSB for the year ended December 31, 2007, as filed with the Federal Reserve System.

**Note 2. Securities**

Amortized cost and fair values of securities available for sale at June 30, 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	\$ 6,960,972	\$ 84,547	\$ (60,720)	\$ 6,984,799
Mortgage backed securities	24,790,867	154,561	(199,503)	24,745,925
Securities of states and political subdivisions	1,101,389	110	(2,188)	1,099,311
Restricted stock	888,900	-	-	888,900
Total	<u>\$ 33,742,128</u>	<u>\$ 239,218</u>	<u>\$ (262,411)</u>	<u>\$ 33,718,935</u>

Amortized cost and fair values of securities held to maturity at June 30, 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	\$ 1,300,294	\$ 8,683	\$ -	\$ 1,308,977
Mortgage backed securities	521,201	-	(4,662)	516,539
Total	<u>\$ 1,821,495</u>	<u>\$ 8,683</u>	<u>\$ (4,662)</u>	<u>\$ 1,825,516</u>

Amortized cost and fair values of securities available for sale 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	\$ 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	511,550	-	-	511,550
Total	<u>\$ 26,277,983</u>	<u>\$ 277,478</u>	<u>\$ (22,054)</u>	<u>\$ 26,533,407</u>

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	<u>\$ 3,203,906</u>	<u>\$ 24,901</u>	<u>\$ (1,293)</u>	<u>\$ 3,227,514</u>

At June 30, 2008 and December 31, 2007, approximately \$1,610,000 and \$1,100,000 of securities were pledged, respectively, to secure deposits of the Commonwealth of Virginia. At June 30, 2008 and December 31, 2007, approximately \$8,995,895 and \$0 of securities were pledged, respectively, to secure advances at the Federal Home Loan Bank.

For the six months ended June 30, 2008 and June 30, 2007, proceeds from calls of securities available for sale totaled \$5,150,556 and \$910,570, respectively. For the six months ended June 30, 2008 and June 30, 2007, proceeds from sales of securities available for sale totaled \$1,188,480 and \$0, respectively.

For the six months ended June 30, 2008 and June 30, 2007, proceeds from calls of securities held to maturity totaled \$1,332,306 and \$0, respectively.

At June 30, 2008, 32 investment securities had an unrealized loss. 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 was 1 investment security held at June 30, 2008 that had been in an unrealized loss position for greater than 12 months. This bond had a total unrealized loss of \$9 and a market value of \$5,394 at June 30, 2008. The remaining 31 securities had a total unrealized loss of \$267,064 and a market value of \$16,146,037 at June 30, 2008. 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.

<b>June 30, 2008</b>	<b>Less Than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
<b>Description of Securities</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>
Securities of U.S. government and federal agencies	\$ 1,933,750	(\$ 60,720)	\$ - -	\$ - -	\$1,933,750	(\$ 60,720)
Mortgage backed securities	13,363,085	(204,156)	5,394	(9)	13,368,478	( 204,165)
Securities of states and political subdivisions	849,202	(2,188)	- -	- -	849,202	(2,188)
Total temporarily impaired securities	<u>\$16,146,037</u>	<u>(\$267,064)</u>	<u>\$ 5,394</u>	<u>(\$ 9)</u>	<u>\$16,151,430</u>	<u>(\$267,073)</u>

  

<b>December 31, 2007</b>	<b>Less Than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
<b>Description of Securities</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>
Obligations 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 consolidated loan portfolio was composed of the following at the dates indicated:

	<u>June 30,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
Mortgage:		
Construction and land development	\$ 13,434,039	\$ 13,481,473
Residential real estate	16,229,118	15,032,853
Nonresidential	11,281,708	9,227,496
Commercial	12,963,905	11,580,579
Agricultural and Other Farm Loans	537,886	545,586
Consumer and All Other Loans	4,700,891	4,407,673
	<u>59,147,546</u>	<u>54,275,660</u>
Unearned income	126,591	125,773
Allowance for loan losses	523,653	491,383
Loans, net	<u>\$ 58,497,302</u>	<u>\$ 53,658,504</u>

Overdrafts totaling \$16,839 and \$14,767 at June 30, 2008 and December 31, 2007, respectively, were reclassified from deposits to loans.

Non-performing assets totaled \$0 and \$62,610 at June 30, 2008 and December 31, 2007, respectively.

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

	<u>June 30,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>	<u>June 30,</u> <u>2007</u>
Balance at the beginning of the period (January 1)	\$ 491,383	\$ 329,462	\$ 329,462
Provision for loan losses	42,100	190,700	14,600
Loans charged off	(11,586)	(31,621)	(558)
Recoveries on loans previously charged off	1,756	2,842	1,069
Balance at the end of the period	<u>\$ 523,653</u>	<u>\$ 491,383</u>	<u>\$ 344,573</u>

**Note 4. Earnings Per Share**

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

	Six months ended June 30, 2008		Three months ended June 30, 2008	
	Shares	Amount	Shares	Amount
Basic earnings per share	610,175	\$ 0.11	610,175	\$ 0.00
Effect of dilutive securities:				
Stock Options	-		-	
Diluted earnings per share	<u>610,175</u>	\$ 0.11	<u>610,175</u>	\$ 0.00

  

	Six months ended June 30, 2007		Three months ended June 30, 2007	
	Shares	Amount	Shares	Amount
Basic earnings per share	607,827	\$ 0.26	607,977	\$ 0.14
Effect of dilutive securities:				
Stock Options	8,912		9,029	
Diluted earnings per share	<u>616,739</u>	\$ 0.26	<u>617,006</u>	\$ 0.14

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 reflect additional common shares that would have been outstanding if potential dilutive common shares had been issued, as well as any adjustment to income that would result from issuance. For the three and six month periods ended June 30, 2008, stock options representing 32,354 potential shares were excluded from the calculation of diluted earnings per share as their effect would have been anti-dilutive.

**Note 5. Stock Based Compensation**

As of June 30, 2008, the Bank had a stock based compensation plan. Prior to January 1, 2006, the Bank accounted for stock based compensation utilizing the intrinsic value method in accordance with the provision of APB Opinion 25 and related interpretations. Accordingly, no compensation expense was recognized for the stock option plan because the exercise prices of stock options granted equaled or exceeded the market price of the underlying stock on the dates of grants. As disclosed in the Bank's Current Report on Form 8-K, dated December 29, 2005, vesting of previously issued stock options was accelerated for options granted February 2005.

Effective January 1, 2006, the Bank adopted the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123R, "Share-Based Payment", using the modified prospective application. Under this method, compensation expense is recorded for all awards granted after the date of adoption and for the unvested portion of previously granted awards that were outstanding as of the beginning of the period of adoption.

The fair value of each grant is estimated at the grant date using the Black-Scholes option-pricing model. There were no stock options granted in 2008 and 2007. There were no options exercised in the six month periods ended June 30, 2008 and 2007, respectively.

The following summarizes the stock option activity for the six month period ended June 30, 2008:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Intrinsic Value of Unexercised In-the-Money Options</u>
Options outstanding, January 1, 2008	32,354	\$ 21.30		
Granted	-	-		
Exercised	-	-		
Forfeited	-	-		
Options outstanding, June 30, 2008	<u>32,354</u>	<u>\$ 21.30</u>	6.18	
Options exercisable, June 30, 2008	<u>32,354</u>	<u>\$ 21.30</u>	6.18	\$ --

(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 June 30, 2008. This amount changes based on changes in the market value of the Bank's stock. The fair value (present value of the estimated future benefit to the option holder) of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis of the financial condition and results of operations of the Bank for the three and six months ended June 30, 2008 should be read in conjunction with the Bank's Financial Statements and the accompanying Notes to Financial Statements included in this report and in the Bank's Annual Report on Form 10-KSB for the year ended December 31, 2007 (the "2007 Form 10-KSB").

### **Executive Overview**

The Bank is headquartered in Gloucester, Virginia. 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 of Virginia, as well as the Peninsula of Virginia. The Bank also has an investment division operating under the name of Colonial Virginia Investment Services.

The Bank's results of operations are primarily dependent on net interest income, which is the difference between the income earned on our loans and investment portfolio and the cost of funds, consisting of the interest paid on deposits and borrowings. Results of operations are also affected by our allowance for loan losses, investment activities and other fees. Non-interest expense principally consists of salary 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 materially different financial condition or results of operations is a reasonable likelihood.

#### *Allowance for Loan Losses*

The Bank monitors and maintains an allowance for loan losses 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 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 or too low. 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. Further discussion of the adequacy and analysis of the level of the allowance for loan losses is included below.

## **Financial Summary**

Net income for the three months ended June 30, 2008 was \$25,728 before taxes and \$728 after taxes, or effectively \$0.00 per share assuming dilution, compared to \$83,653 (before and after taxes), or \$0.14 per share assuming dilution, for the same period in 2007. The Bank (which opened November 6, 2003) enjoyed the tax benefit of net operating loss carry forwards during its early years of operation. After fully utilizing these tax benefits through the first quarter of 2008, the Bank expensed \$25,000 during the current quarter for current income tax liability. This entry is a non-cash expense as the current expense accrual represents a reduction of an asset representing a previous period deferred tax refund receivable.

The financial sector continues under tremendous pressure from major loan loss and other asset quality pressures, as well as the compression of net interest margins. The Bank does not suffer from 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, nor the debacle of problem real estate development loans. The drag on earnings as stated above has been declining net interest income.

Net income for the six months ended June 30, 2008 totaled \$66,956 (after the \$25,000 income tax expense discussed above), compared to \$158,547 (with no tax liability) for the six months ended June 30, 2007. Several factors contributed to the earnings decline. Discussed elsewhere in this report, the Bank's net interest income has declined significantly over the past twelve months, as a percentage of average earning assets and average total assets. This was triggered by an extremely volatile interest rate environment. The historic and dramatic falling rate environment has resulted in the "prime" rate declining from 8.25% as of September 17, 2007 to 5.00% as of April 30, 2008. While the Bank's balance sheet growth has reflected steady increases in average earning assets, the margin or interest rate spread between the deposit liability funding sources and earning assets has declined. Yields on earning assets have fallen faster than the Bank's overall cost of funds and have not allowed net interest income to grow at the same pace as overall operating expenses.

The following increases in operating expenses also contributed to the overall decline in net income. First, the Bank experienced an increase in salaries and employee benefits expense of \$35,463 and \$78,902, respectively, for the three and six month periods ended June 30, 2008. Second, audit expense for the three and six months ended June 30, 2008 was \$18,750 and \$33,350 greater, respectively, than the same periods in 2007, resulting from increased audit coverage required by the Sarbanes-Oxley Act. Third, FDIC insurance expense for the three and six months ended June 30, 2008 was \$5,458 and \$18,622 greater, respectively, than the same periods in 2007, resulting from strong deposit growth and a change in the FDIC formula for calculating insurance premiums.

For the six months ended June 30, 2008 and June 30, 2007, gross revenues, which are defined as interest income plus other income, were \$3.5 million and \$3.1 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 \$3.4 million and \$2.9 million, respectively. Annualized return on average assets for the six months ended June 30, 2008 and June 30, 2007 was 0.13% and 0.37%, respectively. Annualized return on average equity for the six months ended June 30, 2008 and June 30, 2007 was 1.15% and 2.86%, respectively.

Total assets for the Bank increased to \$107.9 million at June 30, 2008, compared to \$95.5 million at December 31, 2007, representing an increase of \$12.4 million or 13.0%. Total average assets increased 13.3% from \$89.5 million for the year ended December 31, 2007 to \$101.4 million for the six months ended June 30, 2008. Total net loans at June 30, 2008 were \$58.5 million, an increase of \$4.8 million, or 8.9%, from the December 31, 2007 amount of \$53.7 million. The provision for loan losses for the six months ended June 30, 2008 was \$42,100. The allowance for loan losses totaled \$523,653, or 0.89% of total loans outstanding, at June 30, 2008. The methodology for assessing the adequacy of the allowance is discussed further below.

The investment portfolio increased 19.5% to \$35.5 million at June 30, 2008 compared to \$29.7 million at December 31, 2007. The current investment strategy is to employ excess liquidity in securities whose yields will enhance overall interest earnings without creating undue interest rate risk. The early redemption of bonds through "calls", (the option of the bond issuer to redeem the bond early, primarily when interest rates decline), subsided somewhat compared to the previous quarter. The Bank continued its purchasing activity to compensate for the early redemptions from the calls. Investment decisions were targeted at securities with less call or early redemption risk. However, even this aggressive purchase mentality was effective only in maintaining the portfolio at previous levels. Management continues to believe that yields in the loan portfolio are preferable to general investment yields within the bond market. However, current yields in the bond market have improved slightly relative to the overnight Fed funds rate. The Bank continues its posture of not attempting to forecast interest rates in a vacuum; however, activities of the Federal Open Market Committee ("FOMC") are monitored closely. The levels

of interest rate risk and market 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 maturity of individual bonds. Therefore, any unrealized losses reflected relative to current market value do not represent a risk of actually becoming realized losses during the life of these bonds.

Deposits increased \$4.6 million to \$87.5 million at June 30, 2008 from \$82.9 million at December 31, 2007. Time deposits totaled \$65.1 million at June 30, 2008, an increase of \$2.3 million from \$62.8 million at December 31, 2007. The FOMC reduced its target Fed funds rate by 50 basis points on September 18, 2007, which resulted in a corresponding reduction in the “Prime Rate.” The Bank is currently using short-term deposits to mitigate interest rate risk within the funding side of the balance sheet. The Bank will be able to reduce its cost of funds sooner rather than later in what could become a falling rate environment as these 6 and 7 month CDs reach their renewal/repricing dates. Management continues to avoid growth for the sake of growth, unless pricing decisions on increased funding sources can reasonably result in use of those funds at an appropriate interest spread. The softened loan demand mentioned above and weaker yields available in the overall bond market make high cost deposits less attractive.

Shareholders’ equity totaled \$11.4 million at June 30, 2008. This amount represents a decrease of 0.9% from the December 31, 2007 amount of \$11.5 million. Average shareholders’ equity increased 2.7% from \$11.3 million for the year ended December 31, 2007 to \$11.6 million for the six months ended June 30, 2008. The June 30, 2008 figure reflects the \$66,956 net income plus a \$168,910 decrease in other comprehensive income, including the unrealized loss on securities available for sale and the SFAS No. 158 Supplemental Executive Retirement Plan (“SERP”) adjustment. The book value per common share was \$18.69 at June 30, 2008 and \$18.86 at December 31, 2007.

### **Net Interest Income**

Net interest income for the three and six months ended June 30, 2008 totaled \$788,363 and \$1,524,899, respectively, representing an increase of \$18,420 (2.4%) and \$13,641 (0.9%), respectively, over the same periods in 2007. Average earning assets increased \$15.5 million from \$77.7 million for the first six months of 2007 to \$93.2 million for the first six months of 2008. Average interest bearing liabilities increased \$14.7 million from \$67.4 million for the first six months of 2007 to \$82.1 million for the first six months of 2008. The net interest margin (net interest income expressed as a percentage of average earning assets) (“NIM”) was 3.27% for the six months ended June 30, 2008 compared to 3.89% for the six months ended June 30, 2007.

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. The Bank has established itself as a popular source of construction loan financing, typically priced as variable rate loans, floating continuously with the prime rate. Therefore, as a result of FOMC rate cuts, the Bank’s yield on earning assets has been negatively affected to a greater degree than its benefit of reduced cost of funds. The Bank, like many community banks, relies heavily on fixed rate consumer certificates of deposits (“CDs”) for the majority of its funding. Many of these CDs have maturities of 10 to 17 months; thus restricting the Bank’s ability to reduce rates paid, even in an environment of declining rates. The duration of this negative impact 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 has already begun to increase as higher fixed rate CDs are re-pricing downward toward current market levels.

Loan demand has demonstrated moderate strengthening, which bodes well for overall improving yields on average earning assets. Management also continues to seek enhanced yields through the bond portfolio. A strategic decision was made to manage liquidity more deliberately through alternative funding sources such as the Federal Home Loan Bank of Atlanta ("FHLB") and rely less on excess levels of asset liquidity in the form of overnight Fed funds sales.

The Bank utilizes asset liability management modeling software to aid 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 may 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.

The Bank's current balance sheet structure continues to be moderately asset sensitive in the less-than-twelve-month horizon. 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. As discussed above, the moderately asset sensitive position has resulted in compression in the NIM. However, beyond twelve months, fixed rate liabilities begin to demonstrate more rate sensitivity (or repricing volatility) than do variable rate assets. 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.

### **Non-interest Income**

The primary components of non-interest income include service charges on deposit accounts, ATM transaction fees, commissions on credit life insurance, checkbook sales, title insurance, investment services income, mortgage division income and net gains on securities. For the three months and six months ended June 30, 2008, non-interest income of \$70,751 and \$225,335, respectively, represented a \$5,147 (7.8%) and \$102,198 (83.0%) increase, respectively, over the same periods in 2007, details of which are discussed below. Of particular note, the Bank recorded \$63,726 in gains on securities "called" during the quarter ended March 31, 2008, compared to \$0 during the current quarter. Due to the FOMC's dramatic interest rate cuts in the first quarter of 2008, several bonds were redeemed early through the call options of the issuers. When Management purchased these bonds in previous years, with the call risk associated with potential falling rates, they purposely made purchase decisions on bonds that were priced at a discount to "par value", thus, receiving a yield enhancement at early redemption through the calls that were made at par value.

For the three and six months ended June 30, 2008, investment services income totaled \$9,739 and \$22,524, respectively, compared to \$3,312 and \$7,916 for the three and six months ended June 30, 2007, respectively. The cause of the increase is the result of increasing volumes of sales activities within the investment services division. The Bank continues to expand relationships of existing deposit and loan customers attracting additional investment services customers.

The Bank's mortgage services division, Colonial Virginia Mortgage, LLC ("CVM"), contributed \$19,544 to non-interest income in the first six months of 2008, compared to \$8,681 in the first six months

of 2007, a 125.1% increase, from steadily increasing volumes of mortgage loan originations. This is expected to continue to increase as monthly volumes of mortgages originated increase. CVM's projected income is expected to enhance the Bank's non-interest income. As mentioned in the previous quarter, the Bank is finalizing details to begin providing 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. CVM's current practice is to commit to permanent mortgages only upon pre-purchase commitment from secondary market investors; therefore, the Bank, in any warehouse line arrangement, would not be incurring any extended interest rate risk. This practice is expected to enhance the Bank's interest income and offset the overall softened loan demand.

### **Non-interest Expense**

Non-interest expense for the three and six month periods ended June 30, 2008 totaled \$812,336 and \$1,616,178, respectively, compared to \$743,344 and \$1,461,248, respectively, for the three and six month periods ended June 30, 2007. Three primary factors contributed to the increase. First, the Bank experienced an increase in salaries and employee benefits expense of \$35,463 and \$78,902, respectively, for the three and six month periods ended June 30, 2008, due primarily to annual raises, promotions and the addition of a new loan officer. Second, audit expense for the three and six months ended June 30, 2008 was \$18,750 and \$33,350 greater, respectively, than the same periods in 2007, resulting from increased audit coverage required by the Sarbanes-Oxley Act. Third, FDIC insurance expense for the three and six months ended June 30, 2008 was \$5,458 and \$18,622 greater, respectively, than the same periods in 2007, resulting from strong deposit growth and a change in the FDIC formula for calculating insurance premiums.

### **Non-GAAP Financial Measure**

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 Management believes provides important information about the Bank's 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 the Bank matures, an efficiency ratio of 60% to 65% is targeted. At June 30, 2008, the Bank's efficiency ratio was 92.34% compared to 89.41% at June 30, 2007. The increase is associated primarily with the decline in the NIM, also discussed above.

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 \$4.0 million per employee at June 30, 2008 compared to \$3.5 million at June 30, 2007.

### **Allowance for Loan Losses**

The allowance for loan losses at June 30, 2008 was \$523,653, compared to \$491,383 at December 31, 2007. The allowance for loan losses was 0.89% of total loans outstanding at June 30, 2008, compared to 0.91% at December 31, 2007. The provision for loan losses was \$42,100 for the six months ended June 30, 2008. The provision for loan 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 loan 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 Allowance for Loan and Lease Losses ("ALLL"). The Bank expensed \$21,050 in provision for loan losses during the current quarter compared to \$8,550 for the same

quarter in 2007. This expense was recognized pursuant to the growing loan volume and challenging economic cycle and not from any increase in loss risk imbedded in the loan portfolio. Asset quality continues to be strong. As of June 30, 2008, the Bank had no repossessed property. Loans past due 90 days or more and still accruing interest at the end of the second quarter 2008 totaled \$151,053. Management believes that the ALLL is adequate to cover credit losses inherent in the loan portfolio at June 30, 2008. The Bank does not engage in “sub-prime lending.”

Management uses a risk-rating system that includes six “pass” (or acceptable) grades, as well as four adverse grades. All loans are evaluated and assigned a risk rating at the time the loan is made. Periodic subsequent review assesses the loan’s performance as well as changes in the borrower’s financial condition. Management incorporates these ratings into its methodology for evaluating the adequacy of the ALLL, as well as its pricing strategies. The methodology was developed as a part of management’s compliance with accounting requirements within SFAS No. 5 and SFAS No. 114, discussed above in “Critical Accounting Policies.” Pursuant to SFAS No. 114, those loans with whom the borrower’s financial condition has deteriorated to a level that results in an adverse risk rating are evaluated individually for impairment. This evaluation is performed monthly and incorporated into the ALLL adequacy analysis, reflecting any respective loss potential for each loan. The methodology also incorporates factors associated with general economic conditions within the Bank’s market, such as employment statistics, housing starts, and building permits. Another element incorporates a potential loss factor for concentrations of credit, such as unsecured loans. Although the Bank only extends unsecured credit to its highest rated customers, any unforeseen reversals experienced by a borrower with unsecured credit could result in a higher risk of potential loss. Using the current methodology, the ALLL has a small surplus balance above the identified embedded risk. Management considers it prudent to maintain a moderate surplus until such time as the loan portfolio is more seasoned and the risk rating methodology has been validated by bank regulators and external loan review activities. During the most recent regulatory and internal independent loan review, there were no material disagreements with the Bank’s internal risk ratings. There was a general consensus that the Bank’s ALLL was below peer group levels but appeared to be adequate for currently identifiable loss risk.

## **Capital Resources**

Shareholders’ equity at June 30, 2008 totaled \$11.4 million compared to \$11.5 million at December 31, 2007. The cause of the decline was an increase in “unrealized losses on available for sale securities” and not actual operating losses. Total common shares outstanding at June 30, 2008 were 610,175.

At June 30, 2008, the Bank’s tier 1 and total risk-based capital ratios were 16.02% and 16.52%, respectively, compared to 17.51% and 18.26% at December 31, 2007. The Bank’s leverage ratio was 10.99% at June 30, 2008, compared to 12.13% 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**

Liquidity represents an institution’s ability to meet present and future financial obligations through either the sale or maturity of existing assets or the acquisition of additional funds through liability management. Liquid assets include cash, interest-bearing deposits with banks, federal funds sold, short-

term investments, securities classified as available for sale and loans and securities maturing within one year. As a result of the Bank's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Bank maintains overall liquidity sufficient to satisfy its depositors' requirements and meet its customers' credit needs.

At June 30, 2008, cash, interest-bearing deposits with financial institutions, federal funds sold and securities available for sale were 43.6% of total deposits and liabilities. Management, through 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 securities available for sale, and unused lines of credit) as a percentage of total assets. The policy requires that this ratio be equal to or greater than 15% of total assets. At June 30, 2008, this ratio was 43.9%. This excess, however, is skewed somewhat in that it includes all securities classified as available for sale ("AFS"). Some of these securities (although identified as AFS) experience fluctuations in market values based on interest rate trends and, from time to time, an unrealized loss. Thus, they are not considered first candidates to be sold to generate liquidity. Some of these securities are amortizing mortgage backed issues that produce routine monthly cash flows. Liability funding sources are also monitored. Demand and savings deposits, interest bearing and non-interest bearing, time deposits under \$100,000 are monitored with a targeted level of 60% or greater as a percentage of total assets. At June 30, 2008, this percentage was 56.9%. The Bank also maintains additional sources of liquidity through "Federal funds purchased" guidance lines with correspondent banks, which totaled \$7.1 million at June 30, 2008. In October 2007, the Bank joined the FHLB. The FHLB offers many services, but the primary service to be utilized by the Bank will be the FHLB's loan programs. As of June 30, 2008, FHLB advances total \$8.0 million. The advances include two loans totaling \$2.0 million each, at fixed rates of 2.3625% for two years and 2.67% for three years, respectively. These rates compared quite favorably to the Bank's average cost of two and three year CDs of greater than 3.50%. The third loan totals \$4.0 million, at a fixed rate of 2.4800% for thirty days. The Bank will not abandon its primary purpose of being a community bank and corporate partner to the markets it serves. However, utilization of alternative funding that is more economically priced will, over the long-term, bode well for net interest earnings.

### **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. During the six months ended June 30, 2008, there has been no material change outside the ordinary course of the Bank's

business in the contractual obligations specified in “Note 9.” Financial Instruments with Off-Balance Sheet Risk” in the Bank’s Annual Report on Form 10-KSB for the year ended December 31, 2007.

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.

### **Recent Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board (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 the criteria for how an acquiring entity in a business combination recognizes the assets acquired and liabilities assumed in the transaction; establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. Acquisition related costs including finder's fees, advisory, legal, accounting valuation and other professional and consulting fees are required to be expensed as incurred. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008 and early implementation is not permitted. The Bank does not expect the implementation to have a material impact on its financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No.160, “Noncontrolling Interests in Consolidated Financial Statements” (SFAS 160). SFAS 160 requires the Bank to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Bank does not expect the implementation of SFAS 160 to have a material impact on its financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. No. 161, “Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Bank does not expect the implementation of SFAS 161 to have a material impact on its financial statements.

### **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:

- the successful management of interest rate risk;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- 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;
- the ability to continue to attract low cost core deposits to fund asset growth;
- managing the cost and implementation on new technology required to compete and to meet increasing regulatory requirements
- problems with technology utilized by the Bank;
- changes in general economic and business conditions in the Bank's market area;
- 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.

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

	Six months Ended June 30, 2008			Six months Ended June 30, 2007		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<b>Assets:</b>						
Interest earning assets:						
Securities						
Taxable	\$30,415,912	\$ 823,816	5.42%	\$20,716,108	\$ 536,437	5.18%
Total securities	30,415,912	823,816	5.42%	20,716,108	536,437	5.18%
Federal funds sold	4,865,736	68,548	2.82%	9,016,611	234,587	5.20%
Deposits at other banks	1,756,958	17,096	1.95%	--	--	--
Loans, net	56,147,780	2,329,769	8.30%	47,975,291	2,208,115	9.21%
Total earning assets	93,186,386	3,239,229	6.95%	77,708,010	2,979,139	7.67%
Less: allowance for loan losses	(504,423)			(337,106)		
Total non-earning assets	8,762,975			8,538,859		
Total assets	101,444,938			85,909,763		
<b>Liabilities and Stockholders' Equity:</b>						
Interest bearing liabilities:						
Checking	3,765,126	27,812	1.48%	3,560,177	26,033	1.46%
Savings and money market deposits	9,607,665	98,654	2.05%	11,833,096	123,940	2.09%
Other time	66,268,519	1,557,115	4.70%	51,977,651	1,317,908	5.07%
Total interest bearing deposits	79,641,310	1,683,581	4.23%	67,370,924	1,467,881	4.36%
Short term borrowings	2,445,055	30,749	2.52%	--	--	--
Total interest bearing liabilities	82,086,365	1,714,330	4.18%	67,370,924	1,467,881	4.36%
Noninterest bearing liabilities:						
Demand deposits	6,661,772			6,611,865		
Other non-interest bearing Liabilities	1,053,653			821,741		
Total liabilities	89,801,790			74,804,530		
Stockholders' equity	11,643,149			11,105,233		
Total liabilities and stockholders' equity	\$101,444,938			\$85,909,763		
Net Interest Income		\$ 1,524,899			\$1,511,258	
Interest rate spread <sup>(1)</sup>			2.77%			3.31%
Net Interest Margin <sup>(2)</sup>			3.27%			3.89%

<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.

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

	Six months Ended June 30, 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	\$30,415,912	\$ 823,816	5.42%	\$23,756,233	\$1,249,201	5.26%
Total securities	30,415,912	823,816	5.42%	23,756,233	1,249,201	5.26%
Federal funds sold	4,865,736	68,548	2.82%	7,698,161	396,230	5.15%
Deposits at other banks	1,756,958	17,096	1.95%	--	--	--
Loans, net	56,147,780	2,329,769	8.30%	49,690,083	4,574,446	9.21%
Total earning assets	93,186,386	3,239,229	6.95%	81,144,477	6,219,877	7.67%
Less: allowance for loan losses	(504,423)			(348,550)		
Total non-earning assets	8,762,975			8,732,791		
Total assets	101,444,938			89,528,718		
<b>Liabilities and Stockholders' Equity:</b>						
Interest bearing liabilities:						
Checking	3,765,126	27,812	1.48%	3,605,565	53,296	1.48%
Savings and money market deposits	9,607,665	98,654	2.05%	11,580,932	245,608	2.12%
Other time	66,268,519	1,557,115	4.70%	55,066,253	2,832,625	5.14%
Total interest bearing deposits	79,641,310	1,683,581	4.23%	70,252,750	3,131,529	4.46%
Short term borrowings	2,445,055	30,749	2.52%	--	--	--
Total interest bearing liabilities	82,086,365	1,714,330	4.18%	70,252,750	3,131,529	4.46%
Noninterest bearing liabilities:						
Demand deposits	6,661,772			7,102,908		
Other non-interest bearing Liabilities	1,053,653			895,571		
Total liabilities	89,801,790			78,251,229		
Stockholders' equity	11,643,149			11,277,489		
Total liabilities and stockholders' equity	\$101,444,938			\$89,528,718		
Net Interest Income		\$ 1,524,899			\$3,088,348	
Interest rate spread <sup>(1)</sup>			2.77%			3.21%
Net Interest Margin <sup>(2)</sup>			3.27%			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.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Not applicable to smaller reporting companies.

**Item 4. 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 under the Securities Exchange Act of 1934, as amended. 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.

The Bank's management is also responsible for establishing and maintaining adequate internal control over financial reporting. 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 June 30, 2008 that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

The Bank's systems of internal control are commensurate with the Bank's relative size as a small public company and, as such, are moderately restricted by the Bank's limited size of staff. Management utilizes detective controls (controls that can be reasonably expected to identify inappropriate, improper or inaccurate financial entries) in the form of extensive reconciliations of general ledger accounts, many of which are performed daily, others weekly or monthly. Due to the limited staff, the absolute segregation of duties to effect ideal preventive controls (controls that are designed to disallow inappropriate, improper or inaccurate financial entries before they are posted to any general ledger accounts) is also limited. Management believes that its risk management practices are appropriate for the Bank's current environment and limited size, but will continue to add staff and increase the level of preventive controls as profits increase.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

None

**Item 1A. Risk Factors**

Not applicable to smaller reporting companies.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

The Annual Meeting of Shareholders of Colonial Virginia Bank was held on May 13, 2008.

The following twelve directors were elected to serve a one year term each expiring at the 2009 annual meeting of shareholders, as follows:

	<u>Votes For</u>	<u>Withheld Authority</u>
(1) Hal D. Bourque	401,470	4,850
(2) Charles F. Dawson	401,470	4,850
(3) William J. Farinholt	398,970	7,350
(4) Joseph F. Fary	401,470	4,850
(5) William D. Fary	401,470	4,850
(6) Walter B. Hurley, Jr.	401,470	4,850
(7) Joseph A. Lombard, Jr.	401,470	4,850
(8) James L. Miller, Jr.	400,970	5,350
(9) Kenneth E. Smith	398,970	7,350
(10) Elsa C. Verbyla	401,470	4,850
(11) David G. Walker	404,470	1,850

The shareholders voted to ratify the appointment of Yount, Hyde & Barbour, P.C. as independent public accountants to audit the books and accounts of the Bank for fiscal year 2008, as follows.

(1) For:	404,470
(2) Against:	0
(3) Abstain:	1,850
(4) Broker Non-Votes:	0

**Item 5. Other Information**

None

**Item 6. Exhibits**

- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a) Certification of Chief Financial Officer
- 32.1 Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. § 1350

## **SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**COLONIAL VIRGINIA BANK**  
(Registrant)

Date: August 14, 2008

By:     /s/ Kenneth E. Smith      
Kenneth E. Smith (on behalf of the Bank and  
as principal financial officer)  
Executive Vice President and  
Chief Financial Officer

## EXHIBIT INDEX

### **Exhibits**

- |      |   |
|------|---|
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer                                       |
| 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer                                       |
| 32.1 | Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. § 1350 |

**Rule 13a-14(a) Certification of Chief Executive Officer**

I, William J. Farinholt, certify that:

1. I have reviewed the Quarterly Report on Form 10-Q for the period ended June 30, 2008 of Colonial Virginia Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2008

/s/ William J. Farinholt  
William J. Farinholt  
Chief Executive Officer

**Rule 13a-14(a) Certification of Chief Financial Officer**

I, Kenneth E. Smith, certify that:

1. I have reviewed the Quarterly Report on Form 10-Q for the period ended June 30, 2008 of Colonial Virginia Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2008

/s/ Kenneth E. Smith  
Kenneth E. Smith  
Chief Financial Officer

**Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. § 1350**

In connection with the Quarterly Report on Form 10-Q for the period ended June 30, 2008 (the "Form 10-Q") of Colonial Virginia Bank (the "Bank"), we, William J. Farinholt, Chief Executive Officer of the Bank, and Kenneth E. Smith, Chief Financial Officer of the Bank, hereby certify pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to our knowledge:

- (a) the Form 10-Q fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended; and
- (b) the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Bank as of and for the periods presented in the Form 10-Q.

By: /s/ William J. Farinholt  
William J. Farinholt  
Chief Executive Officer

Date: August 14, 2008

By: /s/ Kenneth E. Smith  
Kenneth E. Smith  
Chief Financial Officer

Date: August 14, 2008