

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 September 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 November 13, 2008

# COLONIAL VIRGINIA BANK

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## PART I. FINANCIAL INFORMATION

### Item 1. FINANCIAL STATEMENTS

#### COLONIAL VIRGINIA BANK Balance Sheets

	(Unaudited) September 30, 2008	December 31, 2007
	<u>                    </u>	<u>                    </u>
<b>Assets:</b>		
Cash and due from banks	\$ 2,674,099	\$ 2,174,513
Federal funds sold	2,061,000	2,756,458
Securities available for sale, at fair market value	31,636,332	26,533,407
Securities held to maturity (fair market value of \$812,288 in 2008 and \$3,227,514 in 2007)	804,816	3,203,906
Loans, net of allowance for loan losses of \$577,491 in 2008 and \$491,383 in 2007	58,599,248	53,658,504
Bank premises and equipment, net	3,913,737	3,753,744
Bank owned life insurance	2,486,133	2,089,533
Other assets	<u>1,071,581</u>	<u>1,290,036</u>
 Total assets	 <u>\$ 103,246,946</u>	 <u>\$ 95,460,101</u>
 <b>Liabilities and Shareholders' Equity:</b>		
Liabilities:		
Deposits:		
Non-interest bearing demand deposits	\$ 6,900,984	\$ 6,779,679
Savings and interest bearing demand deposits	16,042,532	13,376,847
Time deposits	<u>61,105,657</u>	<u>62,792,174</u>
Total deposits	\$ 84,049,173	\$ 82,948,700
 Accrued expenses and other liabilities	 1,097,382	 1,005,448
FHLB advances	<u>6,500,000</u>	<u>-</u>
Total liabilities	<u>\$ 91,646,555</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)	(634,888)	(724,288)
Accumulated other comprehensive income, net	<u>54,161</u>	<u>49,123</u>
Total shareholders' equity	<u>\$ 11,600,391</u>	<u>\$ 11,505,953</u>
 Total liabilities and shareholders' equity	 <u>\$ 103,246,946</u>	 <u>\$ 95,460,101</u>

See Accompanying Notes to Financial Statements.

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

	(Unaudited)		(Unaudited)	
	Three Months	Three Months	Nine Months	Nine Months
	Ended	Ended	Ended	Ended
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
<b>Interest and Dividend Income</b>				
Interest and fees on loans	\$1,160,472	\$1,171,442	\$3,490,241	\$3,379,558
Interest on securities available for sale				
Taxable	447,036	319,903	1,251,524	846,281
Dividends	9,050	5,102	28,377	15,160
Interest on federal funds sold and other	19,280	108,837	104,925	343,424
Total interest income	<u>\$1,635,838</u>	<u>\$1,605,284</u>	<u>\$4,875,067</u>	<u>\$4,584,423</u>
<b>Interest Expense</b>				
Interest on deposits	\$709,330	\$807,832	\$2,392,910	\$2,275,712
Interest on short-term borrowings	51,189	0	81,939	0
Total interest expense	<u>\$760,519</u>	<u>\$807,832</u>	<u>\$2,474,849</u>	<u>\$2,275,712</u>
Net interest income	\$875,319	\$797,452	\$2,400,218	\$2,308,711
<b>Provision for Loan Losses</b>	<u>66,050</u>	<u>21,050</u>	<u>108,150</u>	<u>35,650</u>
Net interest income after provision for loan losses	<u>\$809,269</u>	<u>\$776,402</u>	<u>\$2,292,068</u>	<u>\$2,273,061</u>
<b>Other Income</b>				
Service charges on deposit accounts	\$19,260	\$22,125	\$64,347	\$66,441
Net gain (loss) on securities	(296)	0	66,430	0
Other service charges, commissions and fees	43,111	41,943	156,633	120,764
Total other income	<u>\$62,075</u>	<u>\$64,068</u>	<u>\$287,410</u>	<u>\$187,205</u>
<b>Other Expense</b>				
Salaries and employee benefits	\$445,060	\$418,419	\$1,332,137	\$1,226,595
Occupancy expense	54,059	51,519	148,686	141,300
Furniture and equipment expense	20,798	18,521	62,851	49,679
Data processing	118,860	113,175	353,359	326,642
Advertising	33,329	36,742	97,847	114,836
Professional fees	45,717	30,368	127,002	77,201
Stationery and supplies	11,913	11,994	31,892	35,107
Postage and freight	9,013	8,432	26,056	27,707
Regulatory assessments	23,374	19,059	65,833	42,897
Insurance	9,633	9,472	26,275	28,583
Taxes	16,235	15,472	49,409	46,804
Directors fees	20,200	17,009	54,800	52,158
Other operating expenses	30,709	23,326	78,931	65,247
Total other expense	<u>\$838,900</u>	<u>\$773,508</u>	<u>\$2,455,078</u>	<u>\$2,234,756</u>
Net Income before income taxes	\$32,444	\$66,962	\$124,400	\$225,510
Income taxes	<u>10,000</u>	<u>0</u>	<u>35,000</u>	<u>0</u>
Net Income	<u>\$22,444</u>	<u>\$66,962</u>	<u>\$89,400</u>	<u>\$225,510</u>
Earnings per share, basic and diluted	\$0.04	\$0.11	\$0.15	\$0.37
Weighted Average Shares Outstanding, basic	610,175	610,175	610,175	608,618
Weighted Average Shares Outstanding, diluted	610,175	616,009	610,175	616,569

See Accompanying Notes to Financial Statements.

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

	Common Stock	Capital Surplus	Retained (Deficit)	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
<b>Balance at December 31, 2006</b>	\$ 3,038,375	\$ 9,090,243	\$ (821,595)	\$ (280,286)		\$ 11,026,737
Comprehensive income:						
Net income	--	--	225,510	--	\$ 225,510	225,510
Other comprehensive income,						
Change in unrealized loss on securities available for sale, net of deferred taxes	--	--	--	--	182,820	
Change in pension liability, net of deferred taxes	--	--	--	--	22,464	
Other comprehensive income	--	--	--	205,284	\$ 205,284	205,284
Total comprehensive income	--	--	--	--	\$ 430,794	
Exercise of stock options	12,500	40,000	--	--		52,500
<b>Balance at September 30, 2007</b>	<u>\$ 3,050,875</u>	<u>\$ 9,130,243</u>	<u>\$ (596,085)</u>	<u>\$ (75,002)</u>		<u>\$ 11,510,031</u>
<b>Balance at December 31, 2007</b>	\$ 3,050,875	\$ 9,130,243	\$ (724,288)	\$ 49,123		\$ 11,505,953
Comprehensive income:						
Net income	--	--	89,400	--	\$ 89,400	89,400
Other comprehensive income,						
Change in unrealized gain on securities available for sale, net of deferred taxes	--	--	--	--	26,418	
Reclassification adjustment, net of taxes	--	--	--	--	(43,844)	
Change in pension liability, net of deferred taxes	--	--	--	--	22,464	
Other comprehensive income	--	--	--	5,038	\$ 5,038	5,038
Total comprehensive income	--	--	--	--	\$ 94,438	
<b>Balance at September 30, 2008</b>	<u>\$ 3,050,875</u>	<u>\$ 9,130,243</u>	<u>\$ (634,888)</u>	<u>\$ 54,161</u>		<u>\$ 11,600,391</u>

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Statements of Cash Flows**  
**For the Nine Months Ended September 30, 2008**  
**and September 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	\$ 89,400	\$ 225,510
Net (accretion) on investment securities	(10,529)	(71,603)
Depreciation and amortization	193,349	197,548
Provision for loan losses	108,150	35,650
(Gain) on securities	(66,430)	-
Changes in assets and liabilities:		
Decrease (increase) in accrued interest and other assets	192,431	(124,388)
Increase in accrued expenses and other liabilities	149,399	266,798
Net cash provided by operating activities	\$ 655,770	\$ 529,515
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
(Purchase) of securities available for sale	\$ (17,947,374)	\$ (14,792,658)
Principal paydowns of securities	3,348,874	1,593,345
Proceeds from calls and maturities of securities available for sale	8,737,249	6,614,712
Proceeds from sales of securities available for sale	1,225,765	-
(Purchase) of securities held to maturity	-	(1,009,100)
Proceeds from calls and maturities of securities held to maturity	2,347,857	1,450,000
Cancellation (purchase) of Federal Reserve Stock	5,650	(11,400)
(Purchase) of Federal Home Loan Bank Stock	(371,300)	-
Net (increase) in loans	(5,048,894)	(4,857,063)
(Increase) in bank owned life insurance	(396,600)	(522,800)
(Purchase) of premises and equipment	(353,342)	(43,768)
Net cash (used in) investing activities	\$ (8,452,115)	\$ (11,578,732)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in demand, savings, interest-bearing checking and money market deposits	\$ 2,786,990	\$ 2,348,039
Net (decrease) increase in time deposits	(1,686,517)	8,790,774
Net increase in other borrowings	6,500,000	-
Proceeds from sale of stock	-	52,500
Net cash provided by financing activities	\$ 7,600,473	\$ 11,191,313
Net (decrease) increase in cash and cash equivalents	\$ (195,872)	\$ 142,096
<b>CASH AND CASH EQUIVALENTS</b>		
Beginning	\$ 4,930,971	\$ 7,108,048
Ending	\$ 4,735,099	\$ 7,250,144
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid for interest	\$ 2,581,799	\$ 2,237,304
<b>SUPPLEMENTAL DISCLOSURE OF NONCASH ACTIVITIES</b>		
Unrealized (loss) gain on securities available for sale	\$ (26,403)	\$ 182,820
Amortization of adjustment to initially apply SFAS No. 158	22,464	22,464

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Notes to Financial Statements**  
For the Nine Months Ended September 30, 2008  
and September 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 September 30, 2008, the statements of income for the three and nine months ended September 30, 2008, and the changes in shareholders' equity and cash flows for the nine months ended September 30, 2008. Financial statements are prepared in accordance with generally accepted accounting principles. Operating results for the nine month period ended September 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 September 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	\$ 6,250,201	\$ 55,652	\$ (34,554)	\$ 6,271,299
Mortgage backed securities	24,181,222	262,316	(54,318)	24,389,220
Securities of states and political subdivisions	98,690	-	(77)	98,613
Restricted stock	877,200	-	-	877,200
Total	<u>\$ 31,407,313</u>	<u>\$ 317,968</u>	<u>\$ (88,949)</u>	<u>\$ 31,636,332</u>

Amortized cost and fair values of securities held to maturity at September 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	\$ 299,723	\$ 2,341	\$ -	\$ 302,064
Mortgage backed securities	505,093	5,131	-	510,224
Total	<u>\$ 804,816</u>	<u>\$ 7,472</u>	<u>\$ -</u>	<u>\$ 812,288</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 September 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 September 30, 2008 and December 31, 2007, approximately \$9,510,889 and \$0 of securities were pledged, respectively, to secure advances at the Federal Home Loan Bank.

For the nine months ended September 30, 2008 and September 30, 2007, proceeds from calls of securities available for sale totaled \$6,165,441 and \$1,736,410, respectively. For the nine months ended September 30, 2008 and September 30, 2007, proceeds from sales of securities available for sale totaled \$1,225,765 and \$0, respectively.

For the nine months ended September 30, 2008 and September 30, 2007, proceeds from calls of securities held to maturity totaled \$2,347,857 and \$0, respectively.

At September 30, 2008, 21 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 September 30, 2008 that had been in an unrealized loss position for greater than 12 months. This bond had a total unrealized loss of \$2 and a market value of \$1,528 at September 30, 2008. The remaining 20 securities had a total unrealized loss of \$88,947 and a market value of \$9,085,125 at September 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>September 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	\$ 1,960,000	(\$ 34,554)	\$ --	\$ --	\$1,960,000	(\$ 34,554)
Mortgage backed securities	7,026,512	(54,316)	1,528	(2)	7,028,040	( 54,318)
Securities of states and political subdivisions	98,613	(77)	--	--	98,613	(77)
Total temporarily impaired securities	<u>\$ 9,085,125</u>	<u>(\$88,947)</u>	<u>\$ 1,528</u>	<u>(\$ 2)</u>	<u>\$9,086,653</u>	<u>(\$88,949)</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	(10,479)	3,743,194	(16,416)
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>(\$15,479)</u>	<u>\$6,085,919</u>	<u>(\$22,054)</u>

**Note 3. Loans**

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

	<u>September 30,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
Mortgage:		
Construction and land development	\$ 14,105,147	\$ 13,481,473
Residential real estate	17,410,938	15,032,853
Nonresidential	11,682,976	9,227,496
Commercial	10,400,021	11,580,579
Agricultural and Other Farm Loans	476,951	545,586
Consumer and All Other Loans	<u>5,223,978</u>	<u>4,407,673</u>
	59,300,011	54,275,660
Unearned income	123,273	125,773
Allowance for loan losses	<u>577,491</u>	<u>491,383</u>
Loans, net	<u>\$ 58,599,248</u>	<u>\$ 53,658,504</u>

Overdrafts totaling \$27,681 and \$14,767 at September 30, 2008 and December 31, 2007, respectively, were reclassified from deposits to loans.

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

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

	<u>September 30,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>	<u>September 30,</u> <u>2007</u>
Balance at the beginning of the period (January 1)	\$ 491,383	\$ 329,462	\$ 329,462
Provision for loan losses	108,150	190,700	35,650
Loans charged off	(24,298)	(31,621)	(9,259)
Recoveries on loans previously charged off	<u>2,256</u>	<u>2,842</u>	<u>2,841</u>
Balance at the end of the period	<u>\$ 577,491</u>	<u>\$ 491,383</u>	<u>\$ 358,694</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.

	Nine months ended September 30, 2008		Three months ended September 30, 2008	
	Shares	Amount	Shares	Amount
Basic earnings per share	610,175	\$ 0.15	610,175	\$ 0.04
Effect of dilutive securities:				
Stock Options	-		-	
Diluted earnings per share	<u>610,175</u>	\$ 0.15	<u>610,175</u>	\$ 0.04
	Nine months ended September 30, 2007		Three months ended September 30, 2007	
	Shares	Amount	Shares	Amount
Basic earnings per share	608,618	\$ 0.37	610,175	\$ 0.11
Effect of dilutive securities:				
Stock Options	7,951		5,834	
Diluted earnings per share	<u>616,569</u>	\$ 0.37	<u>616,009</u>	\$ 0.11

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 nine month periods ended September 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 September 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 options granted in the nine month periods ended September 30, 2008 and 2007. There were no options exercised in the nine month periods ended September 30, 2008 and 2007, respectively.

The following summarizes the stock option activity for the nine month period ended September 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, September 30, 2008	<u>32,354</u>	<u>\$ 21.30</u>	5.93	
Options exercisable, September 30, 2008	<u>32,354</u>	<u>\$ 21.30</u>	5.93	\$ --

(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 September 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 nine months ended September 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 September 30, 2008 was \$32,444 before taxes and \$22,444 after taxes, or effectively \$0.04 per share assuming dilution, compared to \$66,962 (before and after taxes), or \$0.11 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 and \$10,000 during the second and third quarters of 2008, respectively, 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 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.

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, 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 for the nine months ended September 30, 2008 totaled \$89,400 (after the \$35,000 income tax expense discussed above), compared to \$225,510 (with no tax liability) for the nine months ended September 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 provision for possible loan loss expense was \$66,050 and \$108,150, respectively, for the three and nine month periods ended September 30, 2008, compared to \$21,050 and \$35,650, respectively, for the same periods in 2007. This increase was not prompted by any increase in identified problem loans, but instead in response to nationwide economic conditions that may affect local markets. Therefore, the Bank considers it prudent to recognize these expenses now for the possible need for increased reserves in the future.

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 \$26,641 and \$105,542, respectively, for the three and nine month periods ended September 30, 2008. Second, audit expense for the three and nine months ended September 30, 2008 was \$15,750 and \$49,100 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 nine months ended September 30, 2008 was \$4,315 and \$22,936 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 nine months ended September 30, 2008 and September 30, 2007, gross revenues, which are defined as interest income plus other income, were \$5.2 million and \$4.8 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 \$5.1 million and \$4.5 million, respectively. For the three months ended September 30, 2008 and September 30, 2007, gross revenues were \$1.7 million and \$1.7 million, respectively, while gross expenses were \$1.7 million and \$1.6 million, respectively, resulting in actual net income for the quarters ended September 30, 2008 and 2007 of \$22,444 and \$66,962, respectively. Annualized return on average assets for the nine months ended September 30, 2008 and September, 2007 was 0.12% and 0.34%, respectively. Annualized return on average equity for the nine months ended September 30, 2008 and September 30, 2007 was 1.03% and 2.69%, respectively.

Total assets for the Bank totaled \$103.2 million at September 30, 2008, compared to \$95.5 million at December 31, 2007, representing an increase of \$7.8 million or 8.1%. Total average assets increased 15.4% from \$89.5 million for the year ended December 31, 2007 to \$103.3 million for the nine months ended September 30, 2008. Total average net loans at September 30, 2008 were \$57.4 million, an increase of \$7.7 million, or 15.5%, from the December 31, 2007 amount of \$49.7 million. Greater growth could occur, but the Bank's philosophy has been to not compromise its underwriting standards and sound credit quality for the sake of growth, in order to foster stable earnings without the interruption of unexpected loan losses. The allowance for loan losses totaled \$577,491, or 0.97% of total loans outstanding, at September 30, 2008. The methodology for assessing the adequacy of the allowance is discussed further below.

The investment portfolio increased 9.1% to \$32.4 million at September 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 slightly above 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 \$1.1 million to \$84.0 million at September 30, 2008 from \$82.9 million at December 31, 2007. Time deposits totaled \$61.1 million at September 30, 2008, a decrease of \$1.7 million from \$62.8 million at December 31, 2007. Management has purposely controlled deposit growth, while some larger banks have been driving CD rates up due to their own respective liquidity crises. The costs of some of these higher priced CDs would compress the net interest margin to an unacceptable level. Therefore, the Bank has become more selective in matching competing rates in its local market, especially in circumstances where the depositor maintains no extended relationship with the Bank except for volatile rate-sensitive CDs. As many of these higher priced CDs have reached their maturity, management has been vigilant in aggressively re-pricing them at lower rates or not renewing them. 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.

Shareholders' equity totaled \$11.6 million at September 30, 2008. This amount represents an increase 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 nine months ended September 30, 2008. The September 30, 2008 figure reflects the \$89,400 net income plus a \$5,038 increase 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 \$19.01 at September 30, 2008 and \$18.86 at December 31, 2007.

## Net Interest Income

Net interest income for the three and nine months ended September 30, 2008 totaled \$875,319 and \$2,400,218, respectively, representing an increase of \$77,866 (9.8%) and \$91,507 (4.0%), respectively, over the same periods in 2007. Average earning assets increased \$15.3 million from \$79.5 million for the first nine months of 2007 to \$94.8 million for the first nine months of 2008. Average interest bearing liabilities increased \$14.8 million from \$68.7 million for the first nine months of 2007 to \$83.5 million for the first nine months of 2008. The net interest margin (net interest income expressed as a percentage of average earning assets) (“NIM”) was 3.38% for the nine months ended September 30, 2008 compared to 3.87% for the nine months ended September 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 continues 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 has historically relied heavily on fixed rate consumer certificates of deposits (“CDs”) for the majority of its funding. Many of these CDs have maturities of 7 to 17 months, thus restricting the Bank’s ability to quickly reduce rates paid, even in an environment of declining rates. The Bank’s practice of flooring variable rate loans (contractually limiting how much the individual loan rate can decrease regardless of decreases in market rates) has mitigated the sharp rate decreases by the FOMC, as several variable rate loans have reached their floor rate in the past six months 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 has already begun to increase as higher fixed rate CDs are re-pricing downward toward current market levels.

Loan demand has remained stable during the most recent quarter, despite the vast publicity of the weakening economy, 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 has shifted moderately from an asset sensitive position in the less-than-twelve-month horizon to slightly liability sensitive, as floored loans discussed above have temporarily become “fixed rate”. This condition means that there are more liabilities re-pricing in the

next twelve months than assets. Thus, in a rising rate environment, interest expense might increase more quickly than interest income. Conversely, when interest rates fall, interest expense would decrease more quickly than interest income. As discussed above, the moderately asset sensitive position that existed previously resulted in compression in the NIM. 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 nine months ended September 30, 2008, non-interest income of \$62,075 and \$287,410, respectively, represented a \$1,994 (3.1%) decrease and a \$100,205 (53.5%) 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 a \$296 loss 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 nine months ended September 30, 2008, investment services income totaled \$7,846 and \$30,371, respectively, compared to \$8,392 and \$16,309 for the three and nine months ended September 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 by attracting additional investment services customers.

The Bank’s mortgage services division, Colonial Virginia Mortgage, LLC (“CVM”), contributed \$16,353 to non-interest income in the first nine months of 2008, compared to \$8,186 in the first nine months of 2007, a 99.8% 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 nine month periods ended September 30, 2008 totaled \$838,900 and \$2,455,078, respectively, compared to \$773,509 and \$2,234,756, respectively, for the three and nine month periods ended September 30, 2007. Three primary factors contributed to the increase. First, the Bank experienced an increase in salaries and employee benefits expense of \$26,641 and \$105,542, respectively, for the three and nine month periods ended September 30, 2008, due primarily to annual raises, promotions and the addition of a new loan officer. Second, audit expense for the three and nine months ended September 30, 2008 was \$15,750 and \$49,100 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 nine months ended September 30, 2008 was \$4,315 and \$22,936 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. For the nine months ended September 30, 2008, the Bank's efficiency ratio was 91.35% compared to 89.54% at September 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 \$3.7 million per employee at September 30, 2008 compared to \$3.3 million at September 30, 2007.

### **Allowance for Loan Losses**

The allowance for loan losses at September 30, 2008 was \$577,491, compared to \$491,383 at December 31, 2007. The allowance for loan losses was 0.97% of total loans outstanding at September 30, 2008, compared to 0.91% at December 31, 2007. The provision for loan losses was \$108,150 and \$35,650 for the nine month periods ended September 30, 2008 and 2007, respectively. 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 \$66,050 in provision for loan losses during the current quarter compared to \$21,050 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 September 30, 2008, the Bank had no repossessed property, compared to one repossessed property totaling \$30,000 as of September 30, 2007. Loans past due 90 days or more and still accruing interest at the end of the third quarter 2008 totaled \$2,177, compared to \$661 at the end of the third quarter 2007. Management believes that the ALLL is adequate to cover credit losses inherent in the loan portfolio at September 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 September 30, 2008 totaled \$11.6 million compared to \$11.5 million at December 31, 2007. Total common shares outstanding at September 30, 2008 were 610,175.

At September 30, 2008, the Bank's tier 1 and total risk-based capital ratios were 16.35% and 16.95%, respectively, compared to 17.51% and 18.26% at December 31, 2007. The Bank's leverage ratio was 10.79% at September 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 September 30, 2008, cash, interest-bearing deposits with financial institutions, federal funds sold and securities available for sale were 38.0% 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 September 30, 2008, this ratio was 42.1%. 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 52.5% or greater as a percentage of total assets. At September 30,

2008, this percentage was 65.3%. The Bank also maintains additional sources of liquidity through “Federal funds purchased” guidance lines with correspondent banks, which totaled \$7.1 million at September 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 September 30, 2008, FHLB advances total \$6.5 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 \$2.5 million, at a fixed rate of 3.54% 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 nine months ended September 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 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent’s ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. The Statement also establishes reporting requirements that provide sufficient disclosures to clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 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. 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 how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and 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.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (SFAS 162). This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS 162 becomes effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411. The Bank does not expect the implementation of SFAS 162 to have a material impact on its financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) No. 157-2, “Effective Date of FASB Statement No. 157” (FSP 157-2). FSP 157-2 delays the effective date of SFAS 157, “Fair Value Measurements,” for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the FASB and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157. FSP 157-2 defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for items within the scope of this FSP. Examples of items to which the deferral would and would not apply are listed in the FSP. The Bank does not expect the implementation of FSP 157-2 to have a material impact on its financial statements.

In October 2008, the FASB issued FSP 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 157, “Fair Value Measurements,” in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP was effective upon issuance, including prior periods for which financial statements have not been issued.

## **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;
- changes in general economic and business conditions in the Bank’s market area;
- 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;
- demand, development and acceptance of new products and services, including increasing those which would enhance non-interest income;
- 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 banking and other laws and regulations applicable to the Bank; 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**

	Nine months Ended September 30, 2008			Nine months Ended September 30, 2007		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<b>Assets:</b>						
Interest earning assets:						
Securities						
Taxable	\$31,786,125	\$ 1,279,901	5.37%	\$22,043,595	\$ 861,441	5.21%
Total securities	31,786,125	1,279,901	5.37%	22,043,595	861,441	5.21%
Federal funds sold	3,854,270	77,919	2.70%	8,835,903	343,424	5.18%
Deposits at other banks	1,800,040	27,006	2.00%	--	--	--
Loans, net	57,367,750	3,490,241	8.11%	48,657,280	3,379,558	9.26%
Total earning assets	94,808,185	4,875,067	6.86%	79,536,778	4,584,423	7.69%
Less: allowance for loan losses	(515,040)			(339,853)		
Total non-earning assets	8,996,131			8,715,587		
Total assets	103,289,276			87,912,512		
<b>Liabilities and Stockholders' Equity:</b>						
Interest bearing liabilities:						
Checking	3,958,535	43,504	1.47%	3,662,848	40,206	1.46%
Savings and money market deposits	10,053,322	156,063	2.07%	11,781,734	186,170	2.11%
Other time	65,242,927	2,193,343	4.48%	53,302,318	2,049,336	5.13%
Total interest bearing deposits	79,254,784	2,392,910	4.03%	68,746,900	2,275,712	4.41%
Short term borrowings	4,284,526	81,939	2.55%	--	--	--
Total interest bearing liabilities	83,539,310	2,474,849	3.95%	68,746,900	2,275,712	4.41%
Noninterest bearing liabilities:						
Demand deposits	7,103,933			7,146,733		
Other non-interest bearing Liabilities	1,065,589			852,481		
Total liabilities	91,708,832			76,746,114		
Stockholders' equity	11,580,444			11,166,398		
Total liabilities and stockholders' equity	\$103,289,276			\$87,912,512		
Net Interest Income		\$ 2,400,218			\$2,308,711	
Interest rate spread <sup>(1)</sup>			2.91%			3.27%
Net Interest Margin <sup>(2)</sup>			3.38%			3.87%

<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**

	Nine months Ended September 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	\$31,786,125	\$ 1,279,901	5.37%	\$23,756,233	\$1,249,201	5.26%
Total securities	31,786,125	1,279,901	5.37%	23,756,233	1,249,201	5.26%
Federal funds sold	3,854,270	77,919	2.70%	7,698,161	396,230	5.15%
Deposits at other banks	1,800,040	27,006	2.00%	--	--	--
Loans, net	57,367,750	3,490,241	8.11%	49,690,083	4,574,446	9.21%
Total earning assets	94,808,185	4,875,067	6.86%	81,144,477	6,219,877	7.67%
Less: allowance for loan losses	(515,040)			(348,550)		
Total non-earning assets	8,996,131			8,732,791		
Total assets	103,289,276			89,528,718		
<b>Liabilities and Stockholders' Equity:</b>						
Interest bearing liabilities:						
Checking	3,958,535	43,504	1.47%	3,605,565	53,296	1.48%
Savings and money market deposits	10,053,322	156,063	2.07%	11,580,932	245,608	2.12%
Other time	65,242,927	2,193,343	4.48%	55,066,253	2,832,625	5.14%
Total interest bearing deposits	79,254,784	2,392,910	4.03%	70,252,750	3,131,529	4.46%
Short term borrowings	4,284,526	81,939	2.55%	--	--	--
Total interest bearing liabilities	83,539,310	2,474,849	3.95%	70,252,750	3,131,529	4.46%
Noninterest bearing liabilities:						
Demand deposits	7,103,933			7,102,908		
Other non-interest bearing Liabilities	1,065,589			895,571		
Total liabilities	91,708,832			78,251,229		
Stockholders' equity	11,580,444			11,277,489		
Total liabilities and stockholders' equity	\$103,289,276			\$89,528,718		
Net Interest Income		\$ 2,400,218			\$3,088,348	
Interest rate spread <sup>(1)</sup>			2.91%			3.21%
Net Interest Margin <sup>(2)</sup>			3.38%			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 September 30, 2008 that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

**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**

None

**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: November 13, 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 September 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: November 13, 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 September 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: November 13, 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 September 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: November 13, 2008

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

Date: November 13, 2008