

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

**FORM 10-QSB**

**Quarterly Report under Section 13 or 15(d)  
of the Securities Exchange Act of 1934**

**For the quarterly period ended September 30, 2006**

or

**Transition Report under Section 13 or 15(d)  
of the Exchange Act**

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

**COLONIAL VIRGINIA BANK**

(Exact name of small business issuer 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 23061**

(Address of principal executive offices)

**(804) 695-9300**

(Issuer's telephone number)

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

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

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

607,675 shares of common stock, par value \$5.00 per share,  
outstanding as of November 10, 2006

Transitional Small Business Disclosure Format (check one). Yes  No

# COLONIAL VIRGINIA BANK

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## PART I. FINANCIAL INFORMATION

### Item 1. FINANCIAL STATEMENTS

#### COLONIAL VIRGINIA BANK Balance Sheets

	(Unaudited) September 30, 2006	December 31, 2005
	<u>                    </u>	<u>                    </u>
<b>Assets:</b>		
Cash and due from banks	\$ 1,974,568	\$ 2,087,047
Federal funds sold	9,743,246	5,599,990
Securities available for sale, at fair market value	15,793,612	8,235,924
Securities held to maturity (fair market value of \$2,122,181 in 2006)	2,109,453	-
Loans, net of allowance for loan losses of \$307,433 in 2006 and \$316,372 in 2005	41,644,841	39,375,508
Bank premises and equipment, net	4,242,732	4,396,470
Bank owned life insurance	1,547,514	1,025,314
Other assets	<u>638,215</u>	<u>276,932</u>
 Total assets	 <u>\$ 77,694,181</u>	 <u>\$ 60,997,185</u>
 <b>Liabilities and Shareholders' Equity:</b>		
Liabilities:		
Deposits:		
Non-interest bearing demand deposits	\$ 6,746,312	\$ 6,444,008
Savings and interest bearing demand deposits	13,272,399	13,131,418
Time deposits	<u>46,260,482</u>	<u>30,583,867</u>
Total deposits	\$ 66,279,193	\$ 50,159,293
Accrued expenses and other liabilities	435,188	269,698
Commitments and contingencies	<u>-</u>	<u>-</u>
Total liabilities	<u>\$ 66,714,381</u>	<u>\$ 50,428,991</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 607,675 shares in 2006 and 605,175 shares in 2005	3,038,375	3,025,875
Capital surplus	9,090,243	9,050,243
Retained (deficit)	(1,047,468)	(1,390,189)
Accumulated other comprehensive income (loss), net	<u>(101,350)</u>	<u>(117,735)</u>
Total shareholders' equity	<u>\$ 10,979,800</u>	<u>\$ 10,568,194</u>
 Total liabilities and shareholders' equity	 <u>\$ 77,694,181</u>	 <u>\$ 60,997,185</u>

See Accompanying Notes to Financial Statements.

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

	(Unaudited)		(Unaudited)	
	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
<b>Interest and Dividend Income</b>				
Interest and fees on loans	\$ 998,072	\$ 701,176	\$ 2,811,712	\$ 1,879,794
Interest on securities available for sale				
Taxable	196,368	75,513	422,221	190,683
Dividends	4,790	4,739	14,303	14,202
Interest on federal funds sold and other	116,333	23,761	290,842	86,546
Total interest and dividend income	<u>\$ 1,315,563</u>	<u>\$ 805,189</u>	<u>\$ 3,539,078</u>	<u>\$ 2,171,225</u>
<b>Interest Expense</b>				
Interest on deposits	\$ 562,867	\$ 238,932	\$ 1,404,604	\$ 605,406
Total interest expense	<u>\$ 562,867</u>	<u>\$ 238,932</u>	<u>\$ 1,404,604</u>	<u>\$ 605,406</u>
Net interest income	\$ 752,696	\$ 566,257	\$ 2,134,474	\$ 1,565,819
<b>Provision for Loan Losses</b>	11,050	-	28,150	10,000
Net interest income after provision for loan losses	<u>\$ 741,646</u>	<u>\$ 566,257</u>	<u>\$ 2,106,324</u>	<u>\$ 1,555,819</u>
<b>Other Income</b>				
Service charges on deposit accounts	15,393	11,271	41,615	33,486
Other service charges, commissions and fees	41,937	25,044	106,146	52,030
Total other income	<u>\$ 57,330</u>	<u>\$ 36,315</u>	<u>\$ 147,761</u>	<u>\$ 85,516</u>
<b>Other Expense</b>				
Salaries and employee benefits	\$ 343,661	\$ 276,582	\$ 1,014,381	\$ 808,284
Occupancy expense	58,900	50,200	157,193	141,494
Furniture and equipment expense	14,690	6,144	41,782	15,122
Data processing	105,891	93,762	310,135	281,478
Advertising	22,560	25,833	61,098	56,758
Professional fees	17,968	17,951	54,336	66,441
Stationery and supplies	10,613	7,646	29,330	20,995
Postage and freight	8,857	6,234	24,677	18,531
Directors fees	14,200	6,200	44,855	8,350
Regulatory assessments	6,914	4,570	16,850	11,088
Insurance	9,729	9,502	28,306	25,475
Taxes	20,534	20,497	66,516	57,115
Other operating expenses	23,582	15,075	61,905	38,889
Total other expense	<u>\$ 658,099</u>	<u>\$ 540,196</u>	<u>\$ 1,911,364</u>	<u>\$ 1,550,020</u>
Net Income before income taxes	\$ 140,877	\$ 62,376	\$ 342,721	\$ 91,315
Income taxes	-	-	-	-
Net Income	<u>\$ 140,877</u>	<u>\$ 62,376</u>	<u>\$ 342,721</u>	<u>\$ 91,315</u>
Earnings per share, basic and diluted	\$ 0.23	\$ 0.10	\$ 0.56	\$ 0.15
Weighted Average Shares Outstanding, basic	607,675	605,175	607,675	605,175
Weighted Average Shares Outstanding, diluted	616,245	607,985	614,304	606,557

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Statements of Changes in Shareholders' Equity**  
**For the Nine Months Ended September 30, 2006**  
**and September 30, 2005 (Unaudited)**

	<u>Common Stock</u>	<u>Capital Surplus</u>	<u>Retained (Deficit)</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Comprehensive Income (Loss)</u>	<u>Total</u>
Balance at December 31, 2004	\$ 3,025,875	\$ 9,050,243	\$ (1,544,734)	\$ (27,273)		\$ 10,504,111
Comprehensive Income (Loss):						
Net income (loss)			91,315		\$ 91,315	91,315
Other comprehensive income (loss):						
Unrealized gain on securities available for sale				(44,822)	(44,822)	(44,822)
Total comprehensive (loss)					\$ 46,492	
Balance at September 30, 2005	<u>\$ 3,025,875</u>	<u>\$ 9,050,243</u>	<u>\$ (1,453,419)</u>	<u>\$ (72,095)</u>		<u>\$ 10,550,604</u>
Balance at December 31, 2005	\$ 3,025,875	\$ 9,050,243	\$ (1,390,189)	\$ (117,735)		\$ 10,568,194
Comprehensive Income (Loss):						
Net income			342,721		\$ 342,721	342,721
Other comprehensive income (loss):						
Unrealized (loss) on securities available for sale				16,385	16,385	16,385
Total comprehensive income					<u>359,106</u>	
Exercise of stock options	<u>12,500</u>	<u>40,000</u>				<u>52,500</u>
Balance at September 30, 2006	<u>\$ 3,038,375</u>	<u>\$ 9,090,243</u>	<u>\$ (1,047,468)</u>	<u>\$ (101,350)</u>		<u>\$ 10,979,800</u>

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Statements of Cash Flows**  
**For the Nine Months Ended September 30, 2006**  
**and September 30, 2005 (Unaudited)**

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	2006	2005
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$ 342,721	\$ 91,315
Net amortization of premium on investment securities	(40,114)	13,721
Depreciation and amortization	236,796	153,177
Provision for loan losses	28,150	10,000
Changes in assets and liabilities:		
(Increase) in accrued interest and other assets	(361,282)	(104,983)
Increase in accrued expenses and other liabilities	165,491	93,317
Net cash provided by operating activities	\$ 371,763	\$ 256,547
 <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of securities available for sale	\$ (10,080,998)	\$ (5,931,253)
Principal paydowns of securities available for sale	783,684	1,283,525
Maturities of securities available for sale	1,789,243	2,000,000
Purchase of securities held to maturity	(2,098,772)	-
(Purchase) redemption of Federal Reserve Stock	(3,800)	3,450
Purchase of bank owned life insurance	(522,200)	(512,320)
Net (increase) in loans	(2,297,483)	(7,906,095)
Purchases of premises and equipment	(83,060)	(1,778,245)
Net cash (used in) investing activities	\$ (12,513,386)	\$ (12,840,938)
 <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in demand, savings, interest-bearing checking and money market deposits	\$ 443,285	\$ 4,780,373
Net increase in time deposits	15,676,615	8,034,968
Net increase in Fed funds purchased	-	-
Proceeds from sale of stock	52,500	-
Net cash provided by financing activities	\$ 16,172,400	\$ 12,815,341
 Net increase in cash and cash equivalents	\$ 4,030,777	\$ 230,950
 <b>CASH AND CASH EQUIVALENTS</b>		
Beginning	\$ 7,687,037	\$ 5,682,715
Ending	\$ 11,717,814	\$ 5,913,665
 <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid for interest	1,301,953	556,401
 <b>SUPPLEMENTAL DISCLOSURE OF NONCASH ACTIVITIES</b>		
Unrealized gain (loss) on securities available for sale	16,385	(44,822)

See Accompanying Notes to Financial Statements.

**COLONIAL VIRGINIA BANK**  
**Notes to Financial Statements**  
For the Nine Months Ended September 30, 2006  
and September 30, 2005 (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 was in organization during the period from January 2, 2003 through November 5, 2003. The Bank commenced regular operations on November 6, 2003 and 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, 2006, the statements of income for the three and nine months ended September 30, 2006, and the changes in shareholders' equity and cash flows for the nine months ended September 30, 2006. Financial statements are prepared in accordance with generally accepted accounting principles. Operating results for the three and nine month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. 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, 2005, as filed with the Federal Reserve System.

**Note 2. Securities**

Amortized cost and fair values of securities available for sale at September 30, 2006, 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	\$ 11,491,616	\$ 26,830	\$ (54,666)	\$ 11,463,780
Mortgage backed securities	3,984,829	407	(72,079)	3,913,157
Securities of states and political subdivisions	98,167	-	(1,842)	96,325
Restricted stock	320,350	-	-	320,350
Total	<u>\$ 15,894,962</u>	<u>\$ 27,237</u>	<u>\$ (128,587)</u>	<u>\$ 15,793,612</u>

Amortized cost and fair values of securities held to maturity at September 30, 2006, 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	\$ 1,910,359	\$ 13,028	\$ (244)	\$ 1,923,143
Securities of states and political subdivisions	199,094	-	(56)	199,038
Total	<u>\$ 2,109,453</u>	<u>\$ 13,028</u>	<u>\$ (300)</u>	<u>\$ 2,122,181</u>

Amortized cost and fair values of securities available for sale at December 31, 2005, 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	\$ 3,147,398	\$ -	\$ (41,373)	\$ 3,106,025
Mortgage backed securities	4,791,723	1,799	(77,520)	4,716,002
Securities of states and political subdivisions	97,988	-	(641)	97,347
Restricted stock	316,550	-	-	316,550
Total	<u>\$ 8,353,659</u>	<u>\$ 1,799</u>	<u>\$ (119,534)</u>	<u>\$ 8,235,924</u>

There were no securities held to maturity at December 31, 2005.

At September 30, 2006, approximately \$100,000 of securities were pledged to secure deposits of the Commonwealth of Virginia. At December 31, 2005, no securities were pledged.

There were no proceeds from sales and calls of securities available for sale in the first nine months of 2006 or for the year ended December 31, 2005.

At September 30, 2006, 35 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 were 25 investment securities held at September 30, 2006 that had been in an unrealized loss position for greater than 12 months. These 25 securities had a total unrealized loss of \$109,834 and a market value of \$4,927,223 at September 30, 2006. The remaining 10 securities had a total unrealized loss of \$19,053 and a market value of \$3,605,770 at September 30, 2006. 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, 2006</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	\$2,829,621	(\$16,276)	\$1,810,990	(\$38,634)	\$4,640,611	(\$54,910)
Mortgage backed Securities	577,111	(2,721)	3,019,908	(69,358)	3,597,019	(72,079)
Securities of states and political subdivisions	199,038	(56)	96,325	(1,842)	295,363	(1,898)
Total temporarily impaired securities	<u>\$3,605,770</u>	<u>(\$19,053)</u>	<u>\$4,927,223</u>	<u>(\$109,834)</u>	<u>\$8,532,993</u>	<u>(\$128,887)</u>
<b>December 31, 2005</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	\$2,380,350	(\$17,048)	\$725,675	(\$24,325)	\$3,106,025	(\$41,373)
Mortgage backed Securities	2,748,566	(30,144)	1,764,025	(47,376)	4,512,591	(77,520)
Securities of states and political subdivisions	97,347	(641)	--	--	97,347	(641)
Total temporarily impaired securities	<u>\$5,226,263</u>	<u>(\$47,833)</u>	<u>\$2,489,700</u>	<u>(\$71,701)</u>	<u>\$7,715,963</u>	<u>(\$119,534)</u>

**Note 3. Loans**

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

	<u>September 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
Mortgage:		
Construction and land development	\$ 6,917,730	\$ 6,536,620
Residential real estate	12,308,076	11,447,924
Nonresidential	9,072,614	8,775,476
Commercial	8,529,736	8,981,628
Agricultural and Other Farm Loans	575,457	517,980
Consumer and All Other Loans	4,665,435	3,548,724
	<u>42,069,048</u>	<u>39,808,352</u>
Unearned income	116,774	116,472
Allowance for loan losses	307,433	316,372
Loans, net	<u>\$ 41,644,841</u>	<u>\$ 39,375,508</u>

Overdrafts totaling \$15,949 and \$17,250 at September 30, 2006 and December 31, 2005, respectively, were reclassified from deposits to loans.

The Bank had no non-performing assets at September 30, 2006 or December 31, 2005.

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

	<u>September 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>	<u>September 30,</u> <u>2005</u>
Balance at the beginning of the period (January 1)	\$ 316,372	\$ 305,129	\$ 305,129
Provision for loan losses	28,150	22,850	10,000
Loans charged off	(37,366)	(11,793)	(1,907)
Recoveries on loans previously charged off	277	185	158
Balance at the end of the period	<u>\$ 307,433</u>	<u>\$ 316,372</u>	<u>\$ 313,380</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 dilutive potential common stock. Potential dilutive common stock had no effect on income available to common shareholders.

	Nine months ended September 30, 2006		Three months ended September 30, 2006	
	Shares	Amount	Shares	Amount
Basic earnings per share	607,675	\$ 0.56	607,675	\$ 0.23
Effect of dilutive securities:				
Stock Options	6,629		8,570	
Diluted earnings per share	<u>614,304</u>	\$ 0.56	<u>616,245</u>	\$ 0.23

	Nine months ended September 30, 2005		Three months ended September 30, 2005	
	Shares	Amount	Shares	Amount
Basic earnings per share	605,175	\$ 0.15	605,175	\$ 0.10
Effect of dilutive securities:				
Stock Options	1,382		2,810	
Diluted earnings per share	<u>606,557</u>	\$ 0.15	<u>607,985</u>	\$ 0.10

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 dilutive potential common shares had been issued, as well as any adjustment to income that would result from issuance.

#### **Note 5. Stock Based Compensation**

As of September 30, 2006, the Bank had a stock-based compensation plan. The Bank accounts for the plan under the recognition and measurement principles of the Accounting Principles Board (“APB”) Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. The table immediately below illustrates the effect on net income and earnings per share for the nine month period ended September 30, 2005 had the fair value recognition provisions of the Financial Accounting Standards Board (“FASB”) Statement No. 123, *Accounting for Stock-Based Compensation*, been adopted.

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 was accelerated to December 29, 2005 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 a modified version of prospective application. Under this method, compensation expense will be 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 with the following weighted average assumptions for grants in 2005: price volatility of 4.97%, risk-free interest rate of 4.21%, expected dividend yield of 0% and expected lives of 10 years. There were grants of options to acquire an aggregate of 39,854 shares of common stock in the first quarter of 2005.

The following summarizes the stock option activity for the nine month period ended September 30, 2006:

	<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, 2006	39,854	21.24		
Granted	-	-		
Exercised	(2,500)	21.00		
Forfeited	-	-		
Options outstanding, September 30, 2006	<u>37,354</u>	<u>21.26</u>	8	
Options exercisable, September 30, 2006	<u>37,354</u>	<u>21.26</u>	8	\$ 270,405

The total intrinsic value of in-the-money options exercised during the nine month period ended September 30, 2006 was \$17,500.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

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, 2006 should be read in conjunction with the Bank's Financial Statements and the accompanying Notes to Financial Statements included in this report.

### **Executive Overview**

The Bank is headquartered in Gloucester, Virginia and conducts its primary operations through the Bank. The Bank is a community bank principally serving the Virginia county of Gloucester, but also providing banking services in the overall market known as the Middle Peninsula 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 interest and fees earned on earning assets and the interest expense paid on deposits and other interest bearing liabilities. 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, 2006 was \$140,877 compared to \$62,376 for the same period in 2005. Net income for the nine months ended September 30, 2006 totaled \$342,721 compared to \$91,315 for the nine months ended September 30, 2005. For these same two periods, gross revenues, which are defined as interest income plus other income, were \$3,686,839 and \$2,256,741, respectively, while gross expenses, which are defined as interest expense plus other expenses and the provision for loan losses, were \$3,344,118 and \$2,165,426, respectively. The Bank has steadily built the revenue stream through developing an attractive yielding loan portfolio in contrast to lower yielding investment securities and overnight type liquidity instruments. Discussed further below is the effect of the evolving loan portfolio on the trend line of net interest earnings. Total average assets increased 35.0% from \$51.7 million for the year ended December 31, 2005 to \$70.0 million for the nine months ended September 30, 2006. Average shareholders' equity increased 1.9% from \$10.5 million for the year ended December 31, 2005 to \$10.7 million for the nine months ended September 30, 2006. The September 30, 2006 figure reflects the \$342,721 net income plus a \$16,385 decrease in the unrealized loss on securities available for sale. This is discussed further below. Annualized return on average assets for the nine months ended September 30, 2006 and September 30, 2005 was 0.66% and 0.25%, respectively. Annualized return on average equity for the nine months ended September 30, 2006 and September 30, 2005 was 4.27% and 1.16%, respectively.

Total assets for the Bank increased to \$77.7 million at September 30, 2006, compared to \$61.0 million at December 31, 2005, representing an increase of \$16.7 million or 27.4%. Total net loans at September 30, 2006 were \$41.6 million, an increase of \$2.2 million, or 5.6%, from the December 31, 2005 amount of \$39.4 million. The provision for loan losses for the nine months ended September 30, 2006 was \$28,150. The allowance for loan losses totaled \$307,433, or 0.73% of total loans outstanding, at September 30, 2006. The methodology for assessing the adequacy of the allowance is discussed further below.

The investment portfolio increased 118.3% to \$17.9 million at September 30, 2006 compared to \$8.2 million at December 31, 2005. 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 Bank continues its posture of not attempting to forecast interest rates in a vacuum. The Federal Open Market Committee ("FOMC") suspended its practice of increasing rates during the third quarter 2006. The FOMC had previously increased the target Fed funds overnight interest rate one quarter percent (25 basis points) at each of its meetings from June 2004 through June 2006, for a total of 425 basis points during that period. The predominant economic opinion of the nation's leading forecasters has indicated that the FOMC will likely maintain rates level over the next several months and possibly begin to reduce rates in 2007. The stabilization of the overall interest rate environment during the third quarter has reduced the negative impact on prices of existing bonds in the Bank's portfolio, resulting in reductions in the unrealized losses on securities available for sale. The level 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, the unrealized losses do not represent a risk of actually becoming realized losses during the life of these bonds.

Deposits increased \$16.1 million to \$66.3 million at September 30, 2006 from \$50.2 million at December 31, 2005. Time deposits totaled \$46.3 million at September 30, 2006, an increase of \$15.7 million from \$30.6 million at December 31, 2005. During the third quarter 2006, the Bank experienced increasing competitive pressure from local credit unions on its short-term time deposit (CD) promotions. Therefore, the Bank promoted its 10 and 13 month CDs with the most attractive rates. Management believes that these maturities will best mitigate interest rate risk within the funding side of the balance sheet should the FOMC begin reducing rates before the end of 2007. The Bank would be able to reduce its cost of funds sooner rather than later in a falling rate environment as these 10 and 13 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. Management has established a desired net interest margin target of 4.50%. Net interest income continues to be the Bank's primary source of net revenue and is discussed below.

Shareholders' equity totaled \$11.0 million at September 30, 2006. This amount represents an increase of 3.8% from the December 31, 2005 amount of \$10.6 million. The book value per common share was \$18.07 at September 30, 2006 and \$17.46 at December 31, 2005.

### **Net Interest Income**

Net interest income is the Bank's primary source of earnings and represents the difference between interest and fees earned on earning assets and the interest expense paid on deposits and other interest bearing liabilities. Net interest income for the three and nine months ended September 30, 2006 totaled \$752,696 and \$2,134,474, respectively, representing an increase of \$186,439 (32.9%) and \$568,655 (36.3%), respectively, over the same periods in 2005. Average earning assets increased \$18.8 million from \$43.4 million for the first nine months of 2005 to \$62.2 million for the first nine months of

2006. Average interest bearing liabilities increased \$19.2 million from \$32.7 million for the first nine months of 2005 to \$51.9 million for the first nine months of 2006. The net interest margin (net interest income expressed as a percentage of average earning assets) (“NIM”) was 4.58% for the nine months ended September 30, 2006 compared to 4.81% for the nine months ended September 30, 2005. Moderate fluctuations have occurred in the net interest margin; however, management believes that fluctuations are contained within a reasonable range and do not subject future earnings to material volatility.

The cause of the most recent compression of the NIM is three-fold. First, the FOMC’s decisions to hold rates level during the third quarter slowed the increasing yield of the floating rate segment of the loan portfolio. Second, CDs used to fund many of those floating rate loans, which repriced during the third quarter, were generally repricing upwards in rate and resultant interest costs. Last, the Bank has experienced moderate softening of loan demand in the local market, resulting in a reduction of the loan to deposit ratio. This has resulted in an increase in balance sheet liquidity and corresponding increases in lower yielding short-term earning assets. Therefore, as discussed above, Management will continue to limit growth for growth’s sake, seeking significant deposit increases when attractive lending opportunities exist.

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. 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. Through the use of the modeling techniques mentioned above, management is closely monitoring the volumes of interest bearing liabilities that are scheduled for repricing within the next 90 day, 180 day and one year intervals. The Bank markets 10 and 13 month CDs to manage the interest rate risk associated with being asset sensitive, should the FOMC actually decrease short-term rates within the next twelve months. The Bank also continues its practice of including interest rate floors in new variable rate loan instruments. This measure is designed to guard against exposure to reduced interest income associated with possible falling rates in the future. Bond purchases also are being made with maturities to protect investment yields beyond the next twelve months. Additionally, loans that were originated as three and five year adjustable rate mortgages (“ARMs”) will be repricing upwards to begin offsetting the increased costs related to the repricing of CDs discussed above. The Bank believes that these steps should provide for reduction of further NIM compression.

### **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 and title insurance. For the three and nine months ended September 30, 2006, non-interest income of \$57,330 and \$147,761, respectively, represented a \$21,015 (57.9%) and \$62,245 (72.8%) increase, respectively, over the same periods in 2005. The convenience of Drive-up ATMs has yielded an increase in non-customer use of the Bank’s ATM with resulting increases in non-interest fee income.

Service charges on deposit accounts totaled \$15,393 and \$41,615, respectively, for the first three and nine months of 2006, compared to \$11,271 and \$33,486, respectively for the same periods in 2005, an increase of 36.6% and 24.3%, respectively. This increase is attributable to the continuing growth in the number of new accounts, as there were no specific fee rate increases.

The Bank's investment services division, begun in the fourth quarter of 2005, continues to attract new customers and expand existing bank relationships. As of September 30, 2006, the division had 111 accounts representing 59 households, with \$4.8 million in assets under management. For the three and nine months ended September 30, 2006, investment income totaled \$12,434 and \$21,000, respectively. This division is expected to contribute to long-term non-interest income as critical mass of the associated customer base produces transaction revenues sufficient to more than offset overhead costs.

The Bank began offering a full suite of mortgage services October 1, 2006, through Colonial Virginia Mortgage, LLC ("CVM"). CVM is owned jointly with Johnson Mortgage Company, LLC, of Newport News, Virginia, and each owner possesses 50% ownership of CVM. CVM will make and sell whole loans, and is believed to be a good complement to the Bank's overall lending program. CVM capitalized with \$250,000, each owner contributing \$125,000. A significant enhancement to the Bank's construction lending practices will be the ability to offer single closing construction to permanent mortgage lending. This feature is attractive among customers for convenience and reduced overall costs. Initially, CVM is projected to experience minimal net operating losses due to start-up costs and personnel overhead until mortgage originations reach an average critical mass level of approximately \$10 million annually. CVM's projected income is expected to enhance the Bank's non-interest income. In addition, the Bank will provide a portion of CVM's warehouse line of credit. This line of credit will enable CVM to fund its mortgages at closing until they are sold to secondary market investors, a period which is typically seven to twenty-five days. This practice is expected to enhance the Bank's interest income.

### **Non-interest Expense**

Non-interest expense for the three and nine months ended September 30, 2006 totaled \$658,099 and \$1,911,364, respectively. This represents an increase of 21.8% and 23.3%, respectively, over non-interest expense of \$540,196 and \$1,550,020, respectively, for the same periods of 2005. Two primary factors contributed to the increase. First, salary and employee benefits increased \$67,079 and \$206,097, respectively, for the three and nine months ended September 30, 2006. Salaries and benefits totaled \$343,661 and \$1,014,381, respectively, for the three and nine months ended September 30, 2006, compared to \$276,582 and \$808,284, respectively for the same periods of 2005, an increase of 24.3% and 25.5%, respectively. Management previously restricted salary expansion during the early stages of operation, but gave officers and employees merit raises effective January 1, 2006. The Bank has placed a high value on attracting and retaining quality personnel. The Bank also added additional personnel after occupying the permanent quarters for its main office in the fourth quarter of 2005. These were necessary positions that could not be added while operating in temporary quarters with limited space. Additionally, as discussed above, the Bank hired an individual to operate the investment services division in the fourth quarter of 2005. Second, the directors accepted no fees until June 2005. For the three and nine month periods ended September 30, 2006, directors' fees totaled \$14,200 and \$44,600, respectively, compared to \$6,200 and \$8,350 for the three and nine month periods of 2005.

### **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 a de novo bank, it is expected that this ratio will be extremely high in early periods of operation due to the myriad of startup expenses. As the Bank matures, an efficiency ratio of 60% to 65% is targeted. At September 30, 2006, the Bank's efficiency ratio was 83.75% compared to 93.86% at September 30, 2005. 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 \$3.0 million per employee at September 30, 2006 compared to \$2.6 million at September 30, 2005.

### **Allowance for Loan Losses**

The allowance for loan losses at September 30, 2006 was \$307,433, compared to \$316,372 at December 31, 2005. The allowance for loan losses was 0.73% of total loans outstanding at September 30, 2006, compared to 0.80% at December 31, 2005. The cause for the decrease is discussed below. The provision for loan losses was \$28,150 for the nine months ended September 30, 2006. Management believes that the allowance for loan losses is adequate to cover credit losses inherent in the loan portfolio at September 30, 2006.

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 Allowance for Loan and Lease Losses (ALLL), as well as its pricing strategies. The methodology was developed as a part of management's compliance with accounting requirements within SFAS 5 and SFAS 114, discussed above in "Critical Accounting Policies." This methodology also reflects the provision for loan loss expense to accommodate only the risks associated with this evaluation exercise. During the Bank's first full year of operation (2004), management established an initial ALLL approximating 1.0% of total loans, until such time as the loan portfolio could season to a degree that embedded risk could be more accurately identified. Using the current methodology, the ALLL has a small surplus balance above the identified embedded risk, although the ratio has fallen below the 1.0% threshold. Therefore, the Bank has reduced provision expense additions to the ALLL. The more static level of the ALLL, while the loan portfolio has continued to grow, has resulted in a declining ratio of the ALLL as a percentage of total loans. 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.

The Bank contracted with an independent third party to perform a loan audit and credit review during the most recent quarter. The audit included review of internal controls of loan operations and credit quality, as well as limited validation of the Bank's internal risk rating system. The audit review resulted in no reclassifications of the Bank's internal risk ratings that would have required an additional provision to the ALLL. Management will continue to explore ALLL methodologies used throughout the banking industry to ensure that it is consistently using industry best practices.

### **Capital Resources**

Shareholders' equity at September 30, 2006 totaled \$11.0 million compared to \$10.6 million at December 31, 2005. Total common shares outstanding at September 30, 2006 were 607,675.

At September 30, 2006, the Bank's tier 1 and total risk-based capital ratios were 21.6% and 22.2%, respectively, compared to 23.6% and 24.3% at December 31, 2005. The Bank's leverage ratio was 14.6% at September 30, 2006, compared to 18.3% at December 31, 2005. 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, 2006, cash, interest-bearing deposits with financial institutions, federal funds sold and securities available for sale were 38.8% 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, 2006, this ratio was 44.7%. This excess, however, is skewed somewhat in that it includes all securities classified as available for sale. Some of these securities were purchased in 2004 when interest rates were significantly lower than current rates. Therefore, the majority of these securities have experienced declining market value as rates have increased. 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. Management also has purchased approximately \$2.0 million in "Federal funds substitutes" with maturities of less than nine months. Liability funding sources are also monitored. Demand and savings deposits, interest bearing and non-interest bearing, and time deposits under \$100,000 are monitored with a targeted level of 60% or greater as a percentage of total assets. At September 30, 2006, this percentage was 63.7%. The Bank also maintains additional sources of liquidity through "Federal funds purchase" guidance lines with correspondent banks, which totaled \$7.1 million at September 30, 2006.

The Bank participates in an arrangement with QwickRate, a nationally organized program whereby financial institutions may publish interest rates for CDs of various maturities and attract deposits from other investors (predominantly credit unions). There are no "brokers" or associated "broker fees." The arrangement provides community banks with a vehicle for providing both alternate funding for liquidity purposes, as well as additional asset/liability, interest rate risk management tools. The Bank monitors weekly, the rates offered through QwickRate to determine the most economical sources of funds. To date, local market deposits have proven to be as stable and economical as national market funds. However, both from a funding and interest rate risk perspective, management will maintain the QwickRate relationship as a viable balance sheet management tool.

## **Other Matters**

As previously reported in the Quarterly Report on Form 10-QSB for the period ended June 30, 2006 under "Future Events", the Bank was involved in a check fraud scheme involving a fraudulent check. The Bank settled the claim against it from the paying bank for \$96,742.75 during the third quarter,

issuing a check for that amount. The Bank subsequently filed a claim under its own insurance bond to recover the \$96,742.75 loss, less the policy's \$25,000 deductible. The Bank received its insurance recovery check during the third quarter 2006, resulting in the total cost to the Bank of \$25,000. There were no other claims made by any party.

### **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, 2006, there have been no material changes 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, 2005.

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 Pronouncement**

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140" (SFAS 155). SFAS 155 permits fair value measurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. The Statement also clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133. It establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. Finally, SFAS 155 amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Bank does not expect the implementation of SFAS 155 to have a material impact on its financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, “Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140” (SFAS 156). SFAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into certain servicing contracts. The Statement also requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS 156 permits an entity to choose between the amortization and fair value methods for subsequent measurements. At initial adoption, the Statement permits a one-time reclassification of available for sale securities to trading securities by entities with recognized servicing rights. SFAS 156 also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. This Statement is effective as of the beginning of an entity’s first fiscal year that begins after September 15, 2006. The Bank does not currently have, nor does it plan to enter into, any servicing contracts or maintain on its books any servicing assets. Therefore, this pronouncement is not expected to have any impact on the Bank’s financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Bank does not expect the implementation of SFAS 157 to have a material impact on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132(R)” (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan will be measured as the difference between plan assets at fair value and the benefit obligation. For a pension plan, the benefit obligation is the projected benefit obligation. For any other postretirement plan, the benefit obligation is the accumulated postretirement benefit obligation. SFAS 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The Statement also requires additional disclosure in the notes to financial statements about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The Bank is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employers’ fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Bank does not expect the implementation of SFAS 158 to have a material impact on its financial statements.

In June 2006, the FASB issued Interpretation No. 48, “*Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109*” (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity’s financial statements in accordance with SFAS 109. The Interpretation prescribes a recognition threshold and measurement principles for the financial statement recognition and measurement of tax positions taken or expected to be taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Bank does not expect this pronouncement 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:

- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- operational risk associated with the increasing incidence of check fraud and other external financial scams perpetrated on banks;
- reliance on the Bank’s management team, including its ability to attract and retain key personnel;
- the ability to continue to attract low cost core deposits to fund asset growth;
- 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 successful management of interest rate risk;
- problems with technology utilized by the Bank;
- reliance on third party relationship with Community Bankers Securities for regulatory compliant, accurate and timely processing of securities transactions associated with the Bank’s investment brokerage service offerings;
- reputational risk associated with new investment brokerage service offerings;
- 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; and
- changing trends in customer profiles and behavior.

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**

	September 30, 2006			September 30, 2005		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<b>Assets:</b>						
Interest earning assets:						
Securities - taxable	12,162,305	436,525	4.79%	6,902,737	204,885	3.96%
Federal funds sold	8,004,739	290,842	4.84%	4,134,843	86,546	2.79%
Deposits at other banks	---	---	---	---	---	---
Loans, net	42,023,877	2,811,712	8.92%	32,394,776	1,879,794	7.74%
Total earning assets	62,190,921	3,539,078	7.59%	43,432,356	2,171,225	6.67%
Less: allowance for loan losses	(321,574)			(313,380)		
Total non-earning assets	7,890,142			6,302,101		
Total assets	69,759,489			49,421,077		
<b>Liabilities and Stockholders' Equity:</b>						
Interest bearing liabilities:						
Checking	3,273,733	29,885	1.22%	2,924,801	21,875	1.00%
Savings and money market deposits	10,085,741	143,085	1.89%	9,294,964	93,597	1.34%
Other time	38,540,822	1,231,634	4.26%	20,446,524	489,213	3.19%
Total interest bearing deposits	51,900,297	1,404,604	3.61%	32,666,289	604,685	2.47%
Short term borrowings	---	---	---	29,304	721	3.28%
Total interest bearing liabilities	51,900,297	1,404,604	3.61%	32,695,593	605,406	2.47%
Noninterest bearing liabilities:						
Demand deposits	6,827,513			6,019,291		
Other non-interest bearing liabilities	339,588			194,992		
Total liabilities	59,067,398			38,909,876		
Stockholders' equity	10,692,091			10,511,201		
Total liabilities and stockholders' equity	69,759,489			49,421,077		
Net Interest Income		2,134,474			1,565,819	
Interest rate spread <sup>(1)</sup>			3.98%			4.20%
Net Interest Margin <sup>(2)</sup>			4.58%			4.81%

<sup>(1)</sup> Interest spread is the average yield earned on earning assets, calculated on a fully taxable equivalent basis, 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. 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 Bank's last fiscal quarter 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 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**  
(Small Business Issuer)

Date: November 10, 2006

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-QSB for the period ended September 30, 2006 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 small business issuer as of, and for, the periods presented in this report;
4. The small business issuer'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)) for the small business issuer 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 small business issuer, 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) Evaluated the effectiveness of the small business issuer'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
  - (c) Disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer'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 small business issuer'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 small business issuer's internal control over financial reporting.

Date: November 10, 2006

/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-QSB for the period ended September 30, 2006 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 small business issuer as of, and for, the periods presented in this report;
4. The small business issuer'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)) for the small business issuer 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 small business issuer, 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) Evaluated the effectiveness of the small business issuer'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
  - (c) Disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer'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 small business issuer'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 small business issuer's internal control over financial reporting.

Date: November 10, 2006

/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-QSB for the period ended September 30, 2006 (the "Form 10-QSB") 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-QSB 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-QSB 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-QSB.

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

Date: November 10, 2006

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

Date: November 10, 2006