

Village Bank & Trust Financial Corp.

Form 10-Q

May 14, 2010

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

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

For the quarterly period ended March 31, 2010

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

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

Commission file number: 0-50765

VILLAGE BANK AND TRUST FINANCIAL CORP.  
(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction of  
incorporation or organization)

16-1694602  
(I.R.S. Employer  
Identification No.)

15521 Midlothian Turnpike, Midlothian, Virginia  
(Address of principal executive offices)

23113  
(Zip code)

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

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

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

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

Large Accelerated Filer

Accelerated Filer

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Non - Accelerated Filer  (Do not check if 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.

4,238,348 shares of common stock, \$4.00 par value, outstanding as of May 8, 2010

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## PART I – FINANCIAL INFORMATION

## ITEM 1 – FINANCIAL STATEMENTS

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

|  | March 31,<br>2010<br>(Unaudited) | December 31,<br>2009 |
|--|----------------------------------|----------------------|
| <b>Assets</b>  |                                  |                      |
| Cash and due from banks  | \$ 12,479,089                    | \$ 13,884,581        |
| Federal funds sold   | 34,520,104                       | 6,777,239            |
| Investment securities available for sale   | 41,367,828                       | 54,857,211           |
| Loans held for sale  | 10,525,439                       | 7,506,252            |
| <b>Loans</b>   |                                  |                      |
| Outstandings   | 463,717,444                      | 467,359,664          |
| Allowance for loan losses  | (9,090,947)                      | (10,521,931)         |
| Deferred costs   | 387,441                          | 208,883              |
|  | 455,013,938                      | 457,046,616          |
| Premises and equipment, net  | 27,685,122                       | 27,799,084           |
| Accrued interest receivable  | 2,932,596                        | 3,366,718            |
| Bank owned life insurance  | 5,488,252                        | 5,431,002            |
| Other real estate owned  | 10,714,591                       | 11,278,532           |
| Other assets   | 14,696,314                       | 15,015,708           |
|  | \$ 615,423,273                   | \$ 602,962,943       |
| <b>Liabilities and Stockholders' Equity</b>  |                                  |                      |
| <b>Liabilities</b>   |                                  |                      |
| Deposits   | \$ 510,977,282                   | \$ 498,285,124       |
| Trust preferred securities   | 8,764,000                        | 8,764,000            |
| Federal home loan bank advances  | 29,000,000                       | 29,000,000           |
| Other borrowings   | 14,470,730                       | 14,829,521           |
| Accrued interest payable   | 483,568                          | 501,069              |
| Other liabilities  | 2,366,675                        | 2,641,410            |
| Total liabilities  | 566,062,255                      | 554,021,124          |
| <b>Stockholders' equity</b>  |                                  |                      |
| Preferred stock, \$4 par value, \$1,000 liquidation preference,<br>1,000,000 shares authorized, 14,738 shares issued and outstanding           | 58,952                           | 58,952               |
| Common stock, \$4 par value - 10,000,000 shares authorized;<br>4,230,628 shares issued and outstanding at March 31, 2010 and December 31, 2009 |                                  | 16,922,512           |
| Additional paid-in capital   | 40,598,815                       | 40,568,771           |
| Retained earnings  | (8,377,580)                      | (8,647,731)          |

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|   |            |            |
|---|------------|------------|
| Warrant Surplus                               | 732,479    | 732,479    |
| Discount on preferred stock                   | (600,971)  | (636,959)  |
| Accumulated other comprehensive income (loss) | 26,811     | (56,205)   |
| Total stockholders' equity                    | 49,361,018 | 48,941,819 |

\$ 615,423,273 \$ 602,962,943

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Income Statements  
Three Months Ended March 31, 2010 and 2009  
(Unaudited)

|  | Three Months Ended March 31, |              |
|--|------------------------------|--------------|
|  | 2010                         | 2009         |
| Interest income  |                              |              |
| Loans  | \$ 7,089,244                 | \$ 8,009,697 |
| Investment securities                                  | 357,120                      | 336,458      |
| Federal funds sold                                     | 14,232                       | 7,273        |
| Total interest income                                  | 7,460,596                    | 8,353,428    |
| Interest expense                                       |                              |              |
| Deposits   | 2,510,967                    | 4,003,456    |
| Borrowed funds   | 533,820                      | 443,306      |
| Total interest expense                                 | 3,044,787                    | 4,446,762    |
| Net interest income                                    | 4,415,809                    | 3,906,666    |
| Provision for loan losses                              | 500,000                      | 1,100,000    |
| Net interest income after provision<br>for loan losses | 3,915,809                    | 2,806,666    |
| Noninterest income                                     |                              |              |
| Service charges and fees                               | 407,689                      | 373,119      |
| Gain on sale of loans                                  | 1,171,954                    | 943,116      |
| Gain on sale of assets                                 | 242,936                      | -            |
| Rental income  | 103,671                      | 41,671       |
| Other  | 227,720                      | 98,480       |
| Total noninterest income                               | 2,153,970                    | 1,456,386    |
| Noninterest expense                                    |                              |              |
| Salaries and benefits                                  | 2,767,389                    | 2,464,614    |
| Occupancy  | 509,918                      | 444,044      |
| Equipment  | 217,724                      | 255,618      |
| Supplies   | 134,362                      | 125,825      |
| Professional and outside services                      | 522,809                      | 435,641      |
| Advertising and marketing                              | 89,626                       | 71,495       |
| Expenses related to foreclosed real estate             | 209,828                      | 39,923       |
| FDIC insurance premium                                 | 292,168                      | 95,387       |
| Other operating expense                                | 586,805                      | 444,352      |
| Total noninterest expense                              | 5,330,629                    | 4,376,899    |
| Net income (loss) before income taxes                  | 739,150                      | (113,847)    |
| Income tax expense (benefit)                           | 251,311                      | (38,709)     |
| Net income (loss)                                      | 487,839                      | (75,138)     |
| Preferred stock dividends                              | 181,700                      | -            |



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|  |    |         |    |          |
|--|----|---------|----|----------|
| Net income loss available to common stockholders | \$ | 306,139 | \$ | (75,138) |
| Earnings (loss) per share, basic                 | \$ | 0.07    | \$ | (0.02)   |
| Earnings (loss) per share, diluted               | \$ | 0.07    | \$ | (0.02)   |

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Stockholders' Equity  
Three Months Ended March 31, 2010 and 2009  
(Unaudited)

|  | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings<br>(Deficit) | Warrant    | Discount<br>on<br>Preferred<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income (loss) | Total         |
|--|--------------------|-----------------|----------------------------------|-----------------------------------|------------|--------------------------------------|--|---------------|
| Balance,<br>December 31,<br>2009   | \$ 58,952          | \$ 16,922,512   | \$ 40,568,771                    | \$ (8,647,731)                    | \$ 732,479 | \$ (636,959)                         | \$ (56,205)  | \$ 8,941,819  |
| Amortization<br>of preferred<br>stock<br>discount  | -                  | -               | -                                | (35,988)                          | -          | 35,988                               | -  | -             |
| Preferred stock<br>dividend  | -                  | -               | -                                | (181,700)                         | -          | -                                    | -  | (181,700)     |
| Stock based<br>compensation  | -                  | -               | 30,044                           | -                                 | -          | -                                    | -  | 30,044        |
| Minimum<br>pension<br>adjustment<br>(net of<br>income taxes of<br>2,188)   | -                  | -               | -                                | -                                 | -          | -                                    | 2,145  | 2,145         |
| Net income   | -                  | -               | -                                | 487,839                           | -          | -                                    | -  | 487,839       |
| Change in<br>unrealized gain<br>(loss) on<br>securities<br>available for<br>sale (net of<br>income taxes<br>of \$24,496) | -                  | -               | -                                | -                                 | -          | -                                    | 80,871   | 80,871        |
| Total<br>comprehensive<br>income (loss)  | -                  | -               | -                                | -                                 | -          | -                                    | -  | 570,855       |
| Balance, March<br>31, 2010   | \$ 58,952          | \$ 16,922,512   | \$ 40,598,815                    | \$ (8,377,580)                    | \$ 732,479 | \$ (600,971)                         | \$ 26,811  | \$ 49,361,018 |
| Balance,<br>December 31,<br>2008   | \$ -               | \$ 16,917,488   | \$ 25,737,048                    | \$ 3,453,788                      | \$ -       | \$ -                                 | \$ 54,250  | \$ 46,162,574 |

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|   |    |                 |               |              |       |    |           |               |
|---|----|-----------------|---------------|--------------|-------|----|-----------|---------------|
| Issuance of common stock  | -  | 4,872           | (4,872)       | -            | -     | -  | -         | -             |
| Stock based compensation  | -  | -               | 45,461        | -            | -     | -  | -         | 45,461        |
| Minimum pension adjustment (net of income taxes of \$729)   |    |                 |               |              |       |    | 2,145     | 2,145         |
| Net loss  | -  | -               | -             | (75,138)     | -     | -  | -         | (75,138)      |
| Change in unrealized gain (loss) on securities available for sale (net of income taxes of \$54,089) | -  | -               | -             | -            | -     | -  | (159,086) | (159,086)     |
| Total comprehensive income (loss)   | -  | -               | -             | -            | -     | -  | -         | (232,079)     |
| Balance, March 31, 2009   | \$ | - \$ 16,922,360 | \$ 25,777,637 | \$ 3,378,650 | -\$ - | \$ | (102,691) | \$ 45,975,956 |

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Cash Flows  
Three Months Ended March 31, 2010 and 2009

|   | 2010         | 2009         |
|---|--------------|--------------|
| <b>Cash Flows from Operating Activities</b>   |              |              |
| Net income (loss)   | \$ 487,839   | \$ (75,138)  |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |              |              |
| Depreciation and amortization   | 315,000      | 310,004      |
| Provision for loan losses   | 500,000      | 1,100,000    |
| Write-down of other real estate owned   | 43,000       | -            |
| Gain on securities  | (108,213)    | (8,061)      |
| Gain on loans sold  | (1,171,954)  | (943,116)    |
| Gain on sale of premises and equipment  | (242,936)    | (645)        |
| Gain on sale of other real estate owned   | (68,475)     | -            |
| Stock compensation expense  | 30,044       | 45,461       |
| Proceeds from sale of mortgage loans  | 49,053,958   | 45,065,904   |
| Origination of mortgage loans for sale  | (50,901,191) | (49,328,920) |
| Amortization of premiums and accretion of discounts on securities, net                      | 209,813      | 7,692        |
| Decrease in interest receivable   | 834,122      | 233,682      |
| Increase in bank owned life insurance   | (57,250)     | (59,545)     |
| (Increase) decrease in other assets   | 279,878      | (1,341,837)  |
| Increase (decrease) in interest payable   | (17,501)     | (89,204)     |
| Increase (decrease) in other liabilities  | (274,734)    | 175,954      |
| Net cash used in operating activities   | (1,088,600)  | (4,907,769)  |
| <b>Cash Flows from Investing Activities</b>   |              |              |
| Purchases of available for sale securities  | (2,950,740)  | (6,230,297)  |
| Maturities and calls of available for sale securities                                       | 16,162,000   | 4,473,630    |
| Proceeds from the sale of calls of available for sale securities                            | 299,054      | -            |
| Proceeds from sale of other real estate owned   | 1,568,051    | -            |
| Net increase in loans   | 154,043      | (2,363,098)  |
| Purchases of premises and equipment   | (335,423)    | (120,736)    |
| Proceeds from sale of premises and equipment  | 377,321      | 9,626        |
| Acquisition net of cash required  | -            | -            |
| Net cash used in investing activities   | 15,274,306   | (4,230,875)  |
| <b>Cash Flows from Financing Activities</b>   |              |              |
| Net increase (decrease) in deposits   | 12,692,158   | 16,207,140   |
| Net increase (decrease) in other borrowings   | (358,791)    | (8,872,798)  |
| Dividends on preferred stock  | (181,700)    | -            |
| Net cash provided by financing activities   | 12,151,667   | 7,334,342    |
| Net (decrease) increase in cash and cash equivalents  | 26,337,373   | (1,804,302)  |
| Cash and cash equivalents, beginning of period  | 20,661,820   | 26,600,829   |

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|  |               |               |
|--|---------------|---------------|
| Cash and cash equivalents, end of period                 | \$ 46,999,193 | \$ 24,796,527 |
| Supplemental Schedule of Non Cash Activities             |               |               |
| Real estate owned assets acquired in settlement of loans | \$ 978,635    | \$ 306,124    |

See accompanying notes to consolidated financial statements.

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 - Principles of presentation

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

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

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

Note 2 - Use of estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the statements of financial condition and revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

Note 3 – Earnings (loss) per common share

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

|   | Three Months Ended March 31, |             |
|---|------------------------------|-------------|
|   | 2010                         | 2009        |
| Numerator   |                              |             |
| Net income (loss) - basic and diluted                               | \$ 487,839                   | \$ (75,138) |
| Preferred stock dividend  | 181,700                      | -           |
| Net income (loss) applicable to common stockholders                 | \$ 306,139                   | \$ (75,138) |
| Denominator   |                              |             |
| Weighted average shares outstanding - basic                         | 4,230,628                    | 4,229,981   |
| Dilutive effect of common stock options and restricted stock awards | -                            | -           |
| Weighted average shares outstanding - diluted                       | 4,230,628                    | 4,229,981   |
| Earnings (loss) per share - basic and diluted                       |                              |             |
| Earnings (loss) per share - basic                                   | \$ 0.07                      | \$ (0.02)   |
| Effect of dilutive common stock options                             | -                            | -           |
| Earnings (loss) per share - diluted                                 | \$ 0.07                      | \$ (0.02)   |

Outstanding options and warrants to purchase common stock were considered in the computation of diluted earnings per share for the periods presented. Stock options for 336,005 and 333,955 shares of common stock were not included in computing diluted earnings per share for the three months ended March 31, 2010 and 2009, respectively, because their effects were anti-dilutive. Warrants for 499,029 shares of common stock were not included in computing earnings per share in 2010 because their effects were also anti-dilutive.

#### Note 4 – Investment securities

At March 31, 2010 and December 31, 2009, all of our securities were classified as available-for-sale. The following table presents the composition of our investment portfolio at the dates indicated.

Investment Securities Available-for-Sale  
(Dollars in thousands)

|                             | Par<br>Value | Amortized<br>Cost | Unrealized<br>Gain<br>(Loss) | Estimated<br>Fair<br>Value | Average<br>Yield |
|-----------------------------|--------------|-------------------|------------------------------|----------------------------|------------------|
| March 31, 2010              |              |                   |                              |                            |                  |
| US Government Agencies      |              |                   |                              |                            |                  |
| Within one year             | \$ 12,750    | \$ 12,834         | \$ 20                        | 12,854                     | 2.14%            |
| One to five years           | 16,463       | 17,087            | 61                           | 17,148                     | 3.34%            |
| Five to ten years           | 2,352        | 2,331             | 28                           | 2,359                      | 1.72%            |
| More than ten years         | 1,000        | 981               | 43                           | 1,024                      | 2.80%            |
| Total                       | 32,565       | 33,233            | 152                          | 33,385                     | 2.75%            |
| Mortgage-backed securities  |              |                   |                              |                            |                  |
| One to five years           | 3,464        | 3,580             | 74                           | 3,654                      | 3.54%            |
| Five to ten years           | 220          | 229               | (8)                          | 221                        | 1.39%            |
| More than ten years         | 27           | 28                | -                            | 28                         | 3.04%            |
| Total                       | 3,711        | 3,837             | 66                           | 3,903                      | 3.41%            |
| Municipals                  |              |                   |                              |                            |                  |
| More than ten years         | 2,000        | 2,105             | 5                            | 2,110                      | 5.19%            |
| Other investments           |              |                   |                              |                            |                  |
| More than five years        | 2,000        | 1,974             | (4)                          | 1,970                      | 5.65%            |
| Total investment securities | \$ 40,276    | \$ 41,149         | \$ 219                       | 41,368                     | 3.07%            |
| December 31, 2009           |              |                   |                              |                            |                  |
| \$ -                        |              |                   |                              |                            |                  |
| US Government Agencies      |              |                   |                              |                            |                  |
| One to five years           | \$ 9,000     | \$ 9,315          | \$ (66)                      | 9,249                      | 2.32%            |
| Five to ten years           | 3,000        | 3,029             | 32                           | 3,061                      | 4.50%            |
| More than ten years         | 34,250       | 35,284            | 75                           | 35,359                     | 5.73%            |
| Total                       | 46,250       | 47,628            | 41                           | 47,669                     | 5.70%            |
| Mortgage-backed securities  |              |                   |                              |                            |                  |
| One to five years           | 389          | 435               | (37)                         | 398                        | 4.40%            |
| Five to ten years           | 471          | 471               | 29                           | 500                        | 5.24%            |
| More than ten years         | 3,141        | 3,227             | 53                           | 3,280                      | 5.42%            |
|                             | 4,001        | 4,133             | 45                           | 4,178                      | 5.39%            |
| Municipals                  |              |                   |                              |                            |                  |
| More than ten years         | 1,000        | 1,026             | 1                            | 1,027                      | 5.28%            |
| Other investments           |              |                   |                              |                            |                  |
| More than five years        | 2,000        | 1,973             | 10                           | 1,983                      | 5.65%            |
| Total investment securities | \$ 53,251    | \$ 54,760         | \$ 97                        | 54,857                     | 4.72%            |





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

|  | Securities in a Loss<br>Position for Less Than<br>12 Months |                      | Securities in a Loss<br>Position for More Than<br>12 Months |                      | Total         |                      |
|--|---|----------------------|---|----------------------|---------------|----------------------|
|  | Fair<br>Value   | Unrealized<br>Losses | Fair<br>Value   | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| (in thousands)                           |   |                      |   |                      |               |                      |
| March 31, 2010                           |   |                      |   |                      |               |                      |
| Investment securities available for sale |   |                      |   |                      |               |                      |
| US Government Agencies                   | \$ 10,080   | \$ (43)              | \$ -  | \$ -                 | \$ 10,080     | \$ (43)              |
| Mortgage-backed securities               | 599   | (42)                 | -   | -                    | 599           | (42)                 |
| Municipals                               | 518   | (4)                  | -   | -                    | 518           | (4)                  |
| Other investments                        | 1,970   | (3)                  | -   | -                    | 1,970         | (3)                  |
| Total                                    | \$ 13,167   | \$ (92)              | \$ -  | \$ -                 | \$ 13,167     | \$ (92)              |
| December 31, 2009                        |   |                      |   |                      |               |                      |
| Investment securities available for sale |   |                      |   |                      |               |                      |
| US Government Agencies                   | \$ 19,542   | \$ (264)             | \$ -  | \$ -                 | \$ 19,542     | \$ (264)             |
| Total                                    | \$ 19,542   | \$ (264)             | \$ -  | \$ -                 | \$ 19,542     | \$ (264)             |

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

Note 5 – Deposits

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

|                                     | March 31, 2010 |         | December 31, 2009 |         |
|-------------------------------------|----------------|---------|-------------------|---------|
|                                     | Amount         | %       | Amount            | %       |
| Noninterest bearing demand\$        | 40,329,929     | 7.89%   | \$ 38,520,878     | 7.73%   |
| NOW                                 | 37,105,791     | 7.26%   | 36,441,259        | 7.31%   |
| Money market                        | 105,829,790    | 20.71%  | 115,166,477       | 23.11%  |
| Savings                             | 9,985,487      | 1.95%   | 8,901,299         | 1.79%   |
| Time deposits of \$100,000 and over | 126,119,292    | 24.68%  | 119,352,471       | 23.95%  |
| Other time deposits                 | 191,606,993    | 37.51%  | 179,902,740       | 36.11%  |
| Total                               | \$ 510,977,282 | 100.00% | \$ 498,285,124    | 100.00% |

Note 6 – Trust preferred securities

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, \$5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at March 31, 2010 was 2.42%. The securities may have been redeemed at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. The principal asset of the Trust is \$5.2 million of the Company's junior subordinated debt securities with like maturities and

like interest rates to the Trust Preferred Capital Notes.

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

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

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

#### Note 7 – Stock incentive plan

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

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

|  | Three Months Ended March 31, |                                 |                      |                 | 2009    |                                 |                      |                 |
|--|------------------------------|---------------------------------|----------------------|-----------------|---------|---------------------------------|----------------------|-----------------|
|  | 2010                         |                                 | 2009                 |                 | 2009    |                                 | 2008                 |                 |
|  | Options                      | Weighted Average Exercise Price | Fair Value Per Share | Intrinsic Value | Options | Weighted Average Exercise Price | Fair Value Per Share | Intrinsic Value |
| Options outstanding, beginning of period | 336,005                      | \$ 9.58                         | \$ 4.75              | \$ -            | 333,955 | \$ 9.63                         | \$ 4.77              | \$ -            |
| Granted                                  | -                            | -                               | -                    | -               | -       | -                               | -                    | -               |
| Forfeited                                | -                            | -                               | -                    | -               | -       | -                               | -                    | -               |
| Exercised                                | -                            | -                               | -                    | -               | -       | -                               | -                    | -               |
| Options outstanding, end of period       | 336,005                      | \$ 9.58                         | \$ 4.75              | \$ -            | 333,955 | \$ 9.63                         | \$ 4.77              | \$ -            |

|  |         |         |
|--|---------|---------|
| Options<br>exercisable,<br>end of period | 300,650 | 298,600 |
|--|---------|---------|

During the first quarter of 2009, we granted to certain officers 26,592 restricted shares of common stock with a weighted average fair market value of \$4.60 at the date of grant. These restricted stock awards have three-year graded vesting. Prior to vesting, these shares are subject to forfeiture to us without consideration upon termination of employment under certain circumstances. The total

number of shares underlying non-vested restricted stock and performance share awards was 18,078 and 34,710 at March 31, 2010 and 2009, respectively.

Stock-based compensation expense was \$34,044 and \$45,561 for the three months ended March 31, 2010 and 2009, respectively. Unamortized stock-based compensation related to nonvested share based compensation arrangements granted under the Incentive Plan as of March 31, 2010 and 2009 was \$212,869 and \$441,312, respectively. The time based unamortized compensation of \$212,462 is expected to be recognized over a weighted average period of 1.81 years.

#### Note 8 — Fair value

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

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

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

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

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

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

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

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

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



in arriving at the fair value measure of the underlying collateral and are therefore classified within (Level 3).

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

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

|                                | Carrying<br>Value | Fair Value Measurement at March 31, 2010 Using                                |  |  |
|--------------------------------|-------------------|---|--|--|
|                                |                   | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                                |                   | (in thousands)  |  |  |
| Financial Assets-Recurring     |                   |   |  |  |
| US Government Agencies         | \$ 33,385         | \$ -  | 33,385                                     | \$ -   |
| MBS                            | 3,903             | -   | 3,903                                      | -  |
| Municipals                     | 2,110             | -   | 2,110                                      | -  |
| Other available for sale (1)   | 1,970             | -   | 1,970                                      | -  |
| Financial Assets-Non-Recurring |                   |   |  |  |
| Impaired loans                 | \$ 33,255         | \$ -  | -\$  | 33,255   |
| Real estate owned              | 10,715            | -   | -  | 10,715   |

(1) Excludes restricted stock.



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

(1) Excludes restricted stock.

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

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

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

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

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

Borrowings – The fair value of FHLB borrowings is based on the discounted value of contractual cash flows using the rates currently offered for borrowings of similar remaining maturities. The carrying amounts of federal funds purchased approximate their fair values.

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

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

|   | March 31,<br>2010 |                         | December 31,<br>2009 |                         |
|---|-------------------|-------------------------|----------------------|-------------------------|
|   | Carrying<br>Value | Estimated<br>Fair Value | Carrying<br>Value    | Estimated<br>Fair Value |
| <b>Financial assets</b>                   |                   |                         |                      |                         |
| Cash and cash equivalents                 | \$ 46,999,193     | \$ 46,999,193           | \$ 20,661,820        | \$ 20,661,820           |
| Investment securities available for sale  | 41,367,828        | 41,367,828              | 54,857,211           | 54,857,211              |
| Loans held for sale                       | 10,525,439        | 10,525,439              | 7,506,252            | 7,506,252               |
| Loans                                     | 455,013,938       | 455,913,883             | 457,046,616          | 466,271,730             |
| Accrued interest receivable               | 2,932,596         | 2,932,596               | 3,366,718            | 3,366,718               |
| <b>Financial liabilities</b>              |                   |                         |                      |                         |
| Deposits                                  | 510,977,282       | 508,592,924             | 498,285,124          | 500,979,984             |
| FHLB borrowings                           | 29,000,000        | 29,045,019              | 29,000,000           | 29,011,904              |
| Trust preferred securities                | 8,764,000         | 10,215,897              | 8,764,000            | 8,764,000               |
| Other borrowings                          | 14,470,730        | 15,348,992              | 14,829,521           | 14,829,521              |
| Accrued interest payable                  | 483,568           | 483,568                 | 501,069              | 501,069                 |
| <b>Off-balance-sheet instruments</b>      |                   |                         |                      |                         |
| Undisbursed credit lines                  |                   | 53,834,188              |                      | 49,621,000              |
| Commitments to extend or originate credit |                   | 24,599,943              |                      | 19,078,000              |
| Standby letters of credit                 |                   | 3,906,054               |                      | 4,177,000               |

#### Note 9 – Capital Purchase Program

On May 1, 2009, as part of the Capital Purchase Program established by the U.S. Department of the Treasury (the “Treasury”) under the Emergency Economic Stabilization Act of 2008 (“EESA”), the Company entered into a Letter Agreement and Securities Purchase Agreement—Standard Terms (collectively, the “Purchase Agreement”) with the Treasury, pursuant to which the Company sold (i) 14,738 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$4.00 per share, having a liquidation preference of \$1,000 per share (the “Preferred Stock”) and (ii) a warrant (the “Warrant”) to purchase 499,029 shares of the Company’s common stock at an initial exercise price of \$4.43 per share, subject to certain anti-dilution and other adjustments, for an aggregate purchase

price of \$14,738,000 in cash. The fair value of the preferred stock was estimated using discounted cash flow methodology at an assumed market equivalent rate of 13%, with 20 quarterly payments over a five year period. The fair value of the warrant was estimated

using the Black-Scholes option pricing model, with assumptions of 25% volatility, a risk-free rate of 2.03%, a yield of 6.162% and an estimated life of 5 years. The value attributed to the warrant is being accreted as a discount on the preferred stock using the effective interest rate method over five years.

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

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

#### Note 10 – Recent accounting pronouncements

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

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

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

## ITEM 2 – MANAGEMENT’S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### Caution about forward-looking statements

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

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

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

### General

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

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

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

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

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

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

The Company had net income of \$488,000 for the first quarter of 2010 as compared to a net loss \$(75,000) for the same period in 2009. The most significant factors in our improving earnings was a decline in the provision for loan losses of \$600,000, from \$1,100,000 in 2009 to \$500,000 in 2010, and a decline in our cost of deposits.

Our total assets increased to \$615,423,000 at March 31, 2010 from \$602,963,000 at December 31, 2009, an increase of \$12,460,000, or 2.1%. During the first quarter of 2010 liquid assets (cash and due from banks, federal funds sold and investment securities available for sale) increased by \$12,848,000, loans held for sale increased by \$3,019,000, net portfolio loans decreased by \$(2,033,000), accrued interest receivable decreased by \$(434,000), and other real estate owned decreased by \$(564,000). The net increase in these assets of \$12,460,000 was funded by a \$12,692,000 increase in deposit accounts offset by a decrease in borrowings of \$(359,000).

The following presents management's discussion and analysis of the financial condition of the





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

#### Results of operations

The Company had income totaling \$488,000 and net income available to shareholders of \$306,000, or \$0.07 per share on a fully diluted basis, in the first quarter of 2010 compared to a loss of \$(75,000), or \$(0.02) per share on a fully diluted basis, in the first quarter of 2009. This represents an increase in profitability of \$563,000, and is the first quarter we have been profitable since the third quarter of 2008. The last eighteen months have been difficult for the Company, as well as the banking industry in general, and is a result of unprecedented losses related to the collapse of the real estate market and the resulting depressed economy.

The increase in net earnings during the quarter ended March 31, 2010 resulted primarily decreases in the provision for loan losses and the cost of deposits. The decrease in the provision is due to a slowing of the deterioration of asset quality. The decrease in the provision for loan losses is discussed further under Asset quality and provision for loan losses. Our cost of deposits declined from 3.65% for the first quarter of 2009 to 2.18% for the first quarter of 2010. This decline in cost of deposits is a result of the repricing of higher cost certificates of deposit during the low interest rate environment that has existed for the last eighteen months as well as an effort to change our deposit mix so that we are not so dependent on higher cost deposits. Our mortgage company's profit declined in the first quarter of 2010 compared to 2009 by \$37,000, primarily as a result of start up expenses associated with its new presence in Northern Virginia. The mortgage company closed \$50,901,000 in mortgage loans in the first quarter of 2010 compared to \$49,329,000 in the first quarter of 2009.

#### Net interest income

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

Net interest income for the first quarter of \$4,416,000 represents an increase of \$509,000, or 13%, compared to the first quarter of 2009, and an increase of \$27,000, or 1%, compared to the fourth quarter of 2009. These increases are a result of a decline in the Company's cost of funds, which declined from 3.63% for the first quarter of 2009 to 2.83% for the fourth quarter of 2009 and to 2.36% for the first quarter of 2010.

The Company's net interest margin is not a measurement under accounting principles generally accepted in the United States, but it is a common measure used by the financial services industry to determine how profitably earning assets are funded. Net interest margin is calculated by dividing net interest income by average earning assets. Net interest margin may be affected by interest on nonaccrual loans as any accrued but unpaid interest is deducted from interest income when a loan is placed on nonaccrual status. Conversely, if a nonaccrual loan is returned to performing status, the accrued but unpaid interest is added back to interest income. As our nonaccrual loans have increased, the effect on nonaccrual interest has been more significant (see discussion of nonaccrual loans under Asset quality and provision for loan losses). Management believes presenting our actual net interest margin and our net interest margin adjusted for nonaccrual interest for the



indicated periods is meaningful to the reader in understanding operating performance. Our net interest margin over the last several quarters is provided in the following table:

| Quarter Ended         | Actual | Adjusted<br>for<br>Interest<br>On Non-<br>Accrual<br>Loans |
|-----------------------|--------|--|
| March 31, 2009        | 3.04%  | 3.17%  |
| June 30, 2009         | 3.17%  | 3.27%  |
| September 30,<br>2009 | 3.17%  | 3.32%  |
| December 31,<br>2009  | 3.22%  | 3.27%  |
| March 31, 2010        | 3.26%  | 3.52%  |

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

Average interest-earning assets for the first quarter of 2010 increased by \$27,582,000, or 5%, compared to the first quarter of 2009. The increase in interest-earning assets was due primarily to an increase in investment securities of \$20,540,000 and federal funds sold of \$11,038,000. The average yield on interest-earning assets decreased to 5.51% for the first quarter of 2010 compared to 6.49% for the first quarter of 2009. Many of our loans are indexed to short-term rates affected by the Federal Reserve's decisions about short-term interest rates, and, accordingly, as the Federal Reserve increases or decreases short-term rates, the yield on interest-earning assets is affected. As the Federal Reserve decreased interest rates starting in 2007 and into 2008, decreasing short-term interest rates by 5% over twelve months, the average yield on our interest-earning assets decreased. Additionally, while many of our indexed rate loans have interest rate floors included in their terms, we have decreased rates to loan customers to better reflect the current interest rate environment and, in some limited cases, to facilitate workouts on nonperforming loans.

Our average interest-bearing liabilities increased by \$26,075,000, or 5%, for the first quarter of 2010 compared to the first quarter of 2009. The increase in interest-bearing liabilities was due to growth in average deposits of \$22,450,000. The average cost of interest-bearing liabilities decreased to 2.36% for the first three months of 2010 from 3.63% for the first quarter of 2009. The principal reason for the decrease in liability costs was the reduction in short-term interest rates by the Federal Reserve. See our discussion of interest rate sensitivity below for more information.

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



| Average Balance<br>Sheets<br>(In thousands)             |    | Three Months Ended March 31, 2010 |                                |                             | Three Months Ended March 31, 2009 |                                |                             |
|---|----|-----------------------------------|--------------------------------|-----------------------------|-----------------------------------|--------------------------------|-----------------------------|
|   |    | Average<br>Balance                | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate | Average<br>Balance                | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate |
| Loans net of deferred fees                              | \$ | 469,676                           | \$ 7,000                       | 6.04%                       | \$ 474,419                        | \$ 7,928                       | 6.78%                       |
| Investment securities                                   |    | 46,280                            | 357                            | 3.13%                       | 25,740                            | 337                            | 5.31%                       |
| Loans held for sale                                     |    | 7,208                             | 89                             | 5.01%                       | 6,461                             | 81                             | 5.08%                       |
| Federal funds and other                                 |    | 26,226                            | 14                             | 0.22%                       | 15,188                            | 7                              | 0.19%                       |
| Total interest earning assets                           |    | 549,390                           | 7,460                          | 5.51%                       | 521,808                           | 8,353                          | 6.49%                       |
| Allowance for loan losses and<br>deferred fees          |    | (10,582)                          |                                |                             | (6,221)                           |                                |                             |
| Cash and due from banks                                 |    | 12,031                            |                                |                             | 12,300                            |                                |                             |
| Premises and equipment, net                             |    | 27,774                            |                                |                             | 28,121                            |                                |                             |
| Other assets  |    | 34,324                            |                                |                             | 24,953                            |                                |                             |
| Total assets  | \$ | 612,937                           |                                |                             | \$ 580,961                        |                                |                             |
| Interest bearing deposits                               |    |                                   |                                |                             |                                   |                                |                             |
| Interest checking                                       | \$ | 37,222                            | \$ 135                         | 1.47%                       | \$ 19,122                         | \$ 67                          | 1.42%                       |
| Money market  |    | 111,145                           | 370                            | 1.35%                       | 30,420                            | 132                            | 1.76%                       |
| Savings   |    | 9,391                             | 26                             | 1.12%                       | 6,107                             | 18                             | 1.20%                       |
| Certificates  |    | 309,218                           | 1,980                          | 2.60%                       | 388,877                           | 3,786                          | 3.95%                       |
| Total deposits  |    | 466,976                           | 2,511                          | 2.18%                       | 444,526                           | 4,003                          | 3.65%                       |
| Borrowings  |    | 55,234                            | 534                            | 3.92%                       | 51,609                            | 443                            | 3.48%                       |
| Total interest bearing liabilities                      |    | 522,210                           | 3,045                          | 2.36%                       | 496,135                           | 4,446                          | 3.63%                       |
| Noninterest bearing deposits                            |    | 38,001                            |                                |                             | 36,013                            |                                |                             |
| Other liabilities                                       |    | 3,430                             |                                |                             | 2,746                             |                                |                             |
| Total liabilities                                       |    | 563,641                           |                                |                             | 534,894                           |                                |                             |
| Equity capital  |    | 49,297                            |                                |                             | 46,067                            |                                |                             |
| Total liabilities and capital                           | \$ | 612,938                           |                                |                             | \$ 580,961                        |                                |                             |
| Net interest income before<br>provision for loan losses |    |                                   | \$ 4,415                       |                             |                                   | \$ 3,907                       |                             |
| Interest spread - average yield<br>on interest          |    |                                   |                                |                             |                                   |                                |                             |

|  |       |       |
|--|-------|-------|
| earning assets, less average rate on interest bearing liabilities                                      | 3.15% | 2.86% |
| Annualized net interest margin (net interest income expressed as percentage of average earning assets) | 3.26% | 3.04% |

Asset quality and provision for loan losses

Provisions for loan losses amounted to \$500,000 for the three months ended March 31, 2010 compared to \$1,100,000 for the first quarter of 2009. The decrease in the provision for loan losses in 2010 when compared to 2009 reflects management's recognition of higher provisions for loan losses in previous periods relative to the Bank's current level of nonperforming assets. However, overall asset quality continues to be a concern as there continues to be uncertainty in the economy, our nonperforming assets increased in the first quarter of 2010, and the expenses associated with foreclosed real estate increased from \$40,000 for the first quarter of 2009 to \$210,000 in 2010.

Nonperforming assets consisting of nonaccrual loans and other real estate owned for the indicated periods is as follows (dollars in thousands):

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|                            | March 31,<br>2010 | December 31,<br>2009 | September 30,<br>2009 | June 30,<br>2009 | March 31,<br>2009 |
|----------------------------|-------------------|----------------------|-----------------------|------------------|-------------------|
| Nonaccrual loans           |                   |                      |                       |                  |                   |
| Number                     | 130               | 123                  | 117                   | 96               | 49                |
| Amount                     | \$ 33,255         | \$ 25,913            | \$ 21,916             | \$ 18,795        | \$ 13,369         |
| Other real estate owned    | 10,715            | 11,279               | 11,249                | 4,626            | 3,967             |
| Nonperforming assets       | \$ 43,970         | \$ 37,192            | \$ 33,165             | \$ 23,421        | \$ 17,336         |
| Percentage of total assets | 7.14%             | 6.17%                | 5.35%                 | 3.94%            | 2.99%             |

The increase in nonperforming assets in the first quarter of 2010 is primarily attributable to the addition of five loan relationships that we had previously identified as potential problem loan relationships and had established allowances for loan losses and reflects the continuing economic stress of our lending relationships. To address the asset quality deterioration, in early 2009 additional resources were allocated to bolster collections, workouts and the disposition of nonperforming assets, and those resources were further augmented by the hiring of a Special Assets Officer in the third quarter. Notwithstanding these actions, if the economy continues to be depressed at the levels we have experienced in the latter part of 2008 and into 2009, nonperforming assets may increase in the future. See our discussion of the allowance for loan losses under Allowance for loan losses and Critical accounting policies below.

In addition to the nonperforming assets at March 31, 2010, there were twenty two loans past due 90 days or more totaling \$2,535,000 and still accruing interest, compared to twelve loans totaling \$4,787,000 at December 31, 2009. We believe that these assets are adequately collateralized and are currently recorded at realistically recoverable values. However, economic circumstances related to specific credit relationships are changing, which may impact our assessments of collectability.

The following table reflects details related to asset quality and allowance for loan losses of Village Bank (dollars in thousands):

|   | March 31,<br>2010 | December<br>31,<br>2009 | September<br>30,<br>2009 | June 30,<br>2009 | March 31,<br>2009 |
|---|-------------------|-------------------------|--------------------------|------------------|-------------------|
| Loans 90 days past due and still accruing | \$ 2,535          | \$ 4,787                | \$ 1,661                 | \$ 1,670         | \$ 1,435          |
| Nonaccrual loans                          | 33,255            | 25,913                  | 21,916                   | 18,795           | 13,369            |
| Other real estate owned                   | 10,715            | 11,279                  | 11,249                   | 4,626            | 3,967             |
| Allowance for loan losses                 |                   |                         |                          |                  |                   |
| Beginning balance                         | \$ 10,522         | \$ 9,527                | \$ 9,618                 | \$ 6,849         | \$ 6,059          |
| Provision for loan losses                 | 500               | 3,020                   | 6,000                    | 3,100            | 1,100             |
| Charge-offs                               | (2,114)           | (2,026)                 | (6,091)                  | (336)            | (314)             |
| Recoveries                                | 183               | 1                       | -                        | 5                | 4                 |
| Ending balance                            | \$ 9,091          | \$ 10,522               | \$ 9,527                 | \$ 9,618         | \$ 6,849          |

Ratios

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|                               |        |        |        |        |        |
|-------------------------------|--------|--------|--------|--------|--------|
| Allowance for loan losses to  |        |        |        |        |        |
| Loans, net of unearned income | 1.96%  | 2.25%  | 2.02%  | 2.01%  | 1.45%  |
| Nonaccrual loans              | 27.34% | 40.61% | 43.47% | 51.17% | 51.23% |
| Nonperforming assets to total |        |        |        |        |        |
| assets                        | 7.14%  | 6.17%  | 5.35%  | 3.94%  | 2.99%  |



#### Noninterest income

Noninterest income increased significantly from \$1,456,000 for the three months ended March 31, 2009 to \$2,154,000 for the same period in 2010, an increase of \$698,000, or 48%. This increase in noninterest income is a result of higher gains on loan sales and fees from increased loan production by our mortgage banking subsidiary as well as gains on the sale of land behind one of our branches. Our mortgage banking subsidiary has experienced a significant increase in loan production as a result of the addition of a loan production office in Northern Virginia as well as improved performance from some of our existing loan originators.

#### Noninterest expense

Noninterest expense increased by \$954,000 from the first quarter of 2009 to the first quarter of 2010. The more significant increases in noninterest expense occurred in salaries and benefits of \$303,000, FDIC insurance premiums of \$197,000, and expenses related to foreclosed real estate of \$170,000. The increase in salaries is attributable to the addition of the mortgage company's loan production office in Northern Virginia as well as the startup of a financial services division of the Bank.

#### Income taxes

The provision for income taxes of \$251,000 for the three months ended March 31, 2010 is based upon the results of operations. Certain items of income and expense are reported in different periods for financial reporting and tax return purposes. The tax effects of these temporary differences are recognized currently in the deferred income tax provision or benefit. Deferred tax assets or liabilities are computed based on the difference between the financial statement and income tax bases of assets and liabilities using the applicable enacted marginal tax rate.

The Company must also evaluate the likelihood that deferred tax assets will be recovered from future taxable income. If any such assets are not likely to be recovered, a valuation allowance must be recognized. We determined that a valuation allowance was not required for deferred tax assets as of March 31, 2010. The assessment of the carrying value of deferred tax assets is based on certain assumptions, changes in which could have a material impact on the Company's financial statements.

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Company recorded a franchise tax expense of \$95,000 and \$30,000 for the three months ended March 31, 2010 and 2009, respectively.

#### Loan portfolio

The following table presents the composition of our loan portfolio (excluding mortgage loans held for sale) at the dates indicated.

Loan Portfolio, Net  
(In thousands)

|                                 | March 31, 2010 |        | December 31, 2009 |        |
|---------------------------------|----------------|--------|-------------------|--------|
|                                 | Amount         | %      | Amount            | %      |
| Commercial                      | \$ 35,510      | 7.7%   | \$ 39,576         | 8.5%   |
| Real estate - residential       | 96,238         | 20.8%  | 93,657            | 20.0%  |
| Real estate - commercial        | 246,779        | 53.2%  | 240,830           | 51.5%  |
| Real estate - construction      | 74,110         | 16.0%  | 81,688            | 17.5%  |
| Consumer                        | 11,081         | 2.4%   | 11,609            | 2.5%   |
| Total loans                     | 463,718        | 100.0% | 467,360           | 100.0% |
| Deferred loan costs, net        | 387            |        | 209               |        |
| Less: Allowance for loan losses | (9,091)        |        | (10,522)          |        |
| Total loans, net                | \$ 455,014     |        | \$ 457,047        |        |

Allowance for loan losses

The allowance for loan losses at March 31, 2010 was \$9,091,000, compared to \$10,522,000 at December 31, 2009. The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) at March 31, 2010 and December 31, 2009 was 1.96% and 2.25%, respectively. The reduction in this ratio is attributable to the significant charge-offs of \$2,114,000 we recognized in the first quarter of 2010. This ratio increased to 1.96% at March 31, 2010 from 1.45% at March 31, 2009. The amount of the loan loss provision is determined by an evaluation of the level of loans outstanding, the level of non-performing loans, historical loan loss experience, delinquency trends, underlying collateral values, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions. See our discussion of the allowance for loan losses under Critical accounting policies below.

The following table presents an analysis of the changes in the allowance for loan losses for the periods indicated.

Analysis of Allowance for Loan Losses  
(In thousands)

|   | Three Months Ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2010                            | 2009       |
| Beginning balance   | \$ 10,522                       | \$ 6,059   |
| Provision for loan losses   | 500                             | 1,100      |
| Charge-offs   |                                 |            |
| Commercial and industrial   | \$ (4)                          | \$ -       |
| Real estate - residential   | (115)                           | -          |
| Real estate - commercial  | (1,034)                         | -          |
| Real estate - construction  | (957)                           | (187)      |
| Consumer  | (4)                             | (127)      |
|   | (2,114)                         | (314)      |
| Recoveries  |                                 |            |
| Commercial and industrial   | -                               | -          |
| Real estate - residential   | -                               | -          |
| Real estate - commercial  | -                               | -          |
| Real estate - construction  | 101                             | 3          |
| Consumer  | 82                              | 1          |
|   | 183                             | 4          |
| Net charge-offs   | (1,931)                         | (310)      |
| Ending balance  | \$ 9,091                        | \$ 6,849   |
| Loans outstanding at end of period (1)  | \$ 464,105                      | \$ 472,775 |
| Ratio of allowance for loan losses as a percent of loans outstanding at end of year | 1.96%                           | 1.45%      |
| Average loans outstanding for the period (1)  | \$ 469,676                      | \$ 474,420 |
| Ratio of net charge-offs to average loans outstanding for the period                | 0.45%                           | 0.07%      |

(1) Loans are net of unearned income.

#### Deposits

Deposits increased by \$12,692,000, or 3%, from \$498,285,000 at December 31, 2009 to \$510,977,000 at March 31, 2010, as compared to an increase of \$16,207,000, or 4%, during the first three months of 2009. Checking and savings accounts increased by \$3,558,000, money market accounts decreased by \$9,337,000 and time deposits increased by \$18,471,000. We adjusted our



interest rates on deposit accounts in the first quarter to encourage movement from money market accounts to longer term certificates of deposit to lengthen the maturities of our liabilities with the expectation that interest rates will move higher over the long-term. The cost of our interest bearing deposits declined to 2.18% for the first quarter of 2010 compared to 2.68% for the fourth quarter of 2009 and 3.65% at March 31, 2009.

While the mix of our deposits continues to be weighted toward time deposits, such deposits represent only 62% of total deposits at March 31, 2010 as compared to 80% at March 31, 2009. As our branch network has increased and is more convenient to a larger segment of our targeted customer base, we have experienced a move to a higher percentage of our deposits in checking accounts. We are emphasizing checking account deposit growth at our existing branches.

The variety of deposit accounts that we offer has allowed us to be competitive in obtaining funds and has allowed us to respond with flexibility to, although not to eliminate, the threat of disintermediation (the flow of funds away from depository institutions such as banking institutions into direct investment vehicles such as government and corporate securities). Our ability to attract and retain deposits, and our cost of funds, has been, and is expected to continue to be, significantly affected by money market conditions.

#### Borrowings

We use borrowings to supplement deposits when they are available at a lower overall cost to us or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank of Atlanta ("FHLB"), the Bank is required to own capital stock in the FHLB and is authorized to apply for borrowings from the FHLB. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses to which the advances may be put, as well as on the size of the advances and repayment provisions. Borrowings from the FHLB were \$29,000,000 at March 31, 2010 and December 31, 2009. The FHLB advances are secured by the pledge of first mortgage loans, home equity loans and our FHLB stock. Management currently expects to repay \$5 million of the advances maturing in April 2010 and \$10 million maturing in June 2010 from existing liquidity.

#### Capital resources

Stockholders' equity at March 31, 2010 was \$49,361,000, compared to \$48,942,000 at December 31, 2009. On May 1, 2009, the Company received a \$14,738,000 investment by the United States Department of the Treasury under its Capital Purchase Program (the TARP Program). The TARP Program is a voluntary program designed to provide capital for healthy banks to improve the flow of funds from banks to their customers. Under the TARP Program, the Company issued to the Treasury \$14,738,000 of preferred stock and warrants to purchase 499,030 shares of the Company's common stock at a purchase price of \$4.43 per share. The preferred stock issued by the Company under the TARP Capital Purchase Program carries a 5% dividend for each of the first 5 years of the investment, and 9% thereafter, unless the shares are redeemed by the Company. The \$419,000 increase in equity during the first three months of 2010 was primarily due to net income of \$488,000, an increase of \$83,000 in other comprehensive income related to available for sale investments, and reduced by dividends paid to the U.S. Treasury on the TARP investment of \$181,700.

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, under capitalized, significantly under capitalized, and critically



under capitalized. The Bank meets the criteria to be categorized as a “well capitalized” institution as of March 31, 2010.

During the first quarter of 2005 and the third quarter of 2007, the Company issued \$5.2 and \$3.6 million, respectively in Trust Preferred Capital Notes. The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion.

The following table presents the composition of regulatory capital and the capital ratios at the dates indicated.

Analysis of Capital  
(In thousands)

|  | March 31,<br>2010 | December 31,<br>2009 |
|--|-------------------|----------------------|
| Tier 1 capital                                     |                   |                      |
| Preferred stock                                    | \$ 59             | \$ 59                |
| Common stock                                       | 16,922            | 16,922               |
| Additional paid-in capital                         | 40,599            | 40,569               |
| Retained earnings (deficit)                        | (8,378)           | (8,648)              |
| Warrant Surplus                                    | 732               | 732                  |
| Discount on preferred stock                        | (601)             | (636)                |
| Qualifying trust preferred securities              | 8,764             | 8,764                |
| Total Tier 1 capital                               | 58,097            | 57,762               |
| Tier 2 capital                                     |                   |                      |
| Allowance for loan losses includible in Tier 2 (1) | 6,290             | 6,310                |
| Total Tier 2 capital                               | 6,290             | 6,310                |
| Total risk-based capital                           | 64,387            | 64,072               |
| Risk-weighted assets                               | \$ 500,477        | \$ 500,602           |
| Capital ratios                                     |                   |                      |
| Tier 1 capital to risk-weighted assets             | 11.6%             | 11.5%                |
| Total capital to risk-weighted assets              | 12.9%             | 12.8%                |
| Leverage ratio (Tier 1 capital to average assets)  | 9.5%              | 9.4%                 |
| Equity to total assets                             | 9.5%              | 8.1%                 |

(1) Amount is limited to 1.25 percent of the Company's gross risk weighted assets

#### Liquidity

Liquidity provides us with the ability to meet normal deposit withdrawals, while also providing for the credit needs of customers. We are committed to maintaining liquidity at a level sufficient to protect depositors, provide for reasonable growth, and fully comply with all regulatory requirements.

At March 31, 2010, cash, cash equivalents and investment securities available for sale totaled \$88,367,000, or 14.4% of total assets, which we believe is adequate to meet short-term liquidity



needs.

At March 31, 2010, we had commitments to originate \$82,340,000 of loans as compared to \$72,876,000 at December 31, 2009. The increase is primarily attributable to commitments to make mortgage loans by our mortgage company which will be sold in the secondary market. Fixed commitments to incur capital expenditures were less than \$25,000 at March 31, 2010. Time deposits scheduled to mature in the 12-month period ending March 31, 2011 totaled \$185,595,000 at March 31, 2010. Based on past experience, we believe that a significant portion of such deposits will remain with us. We further believe that loan repayments and other sources of funds such as deposit growth will be adequate to meet our foreseeable short-term and long-term liquidity needs.

#### Interest rate sensitivity

An important element of asset/liability management is the monitoring of our sensitivity to interest rate movements. In order to measure the effects of interest rates on our net interest income, management takes into consideration the expected cash flows from the securities and loan portfolios and the expected magnitude of the repricing of specific asset and liability categories. We evaluate interest sensitivity risk and then formulate guidelines to manage this risk based on management's outlook regarding the economy, forecasted interest rate movements and other business factors. Our goal is to maximize and stabilize the net interest margin by limiting exposure to interest rate changes.

Contractual principal repayments of loans do not necessarily reflect the actual term of our loan portfolio. The average lives of mortgage loans are substantially less than their contractual terms because of loan prepayments and because of enforcement of due-on-sale clauses, which gives us the right to declare a loan immediately due and payable in the event, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. In addition, certain borrowers increase their equity in the security property by making payments in excess of those required under the terms of the mortgage.

The sale of fixed rate loans is intended to protect us from precipitous changes in the general level of interest rates. The valuation of adjustable rate mortgage loans is not as directly dependent on the level of interest rates as is the value of fixed rate loans. As with other investments, we regularly monitor the appropriateness of the level of adjustable rate mortgage loans in our portfolio and may decide from time to time to sell such loans and reinvest the proceeds in other adjustable rate investments.

The data in the following table reflects repricing or expected maturities of various assets and liabilities at March 31, 2010. The gap analysis represents the difference between interest-sensitive assets and liabilities in a specific time interval. Interest sensitivity gap analysis presents a position that existed at one particular point in time, and assumes that assets and liabilities with similar repricing characteristics will reprice at the same time and to the same degree.

Village Bank and Trust Financial Corp.  
Interest Rate Sensitivity GAP Analysis  
March 31, 2010  
(In thousands)

|  | Within 3<br>Months | 3 to 6<br>Months   | 6 to 12<br>Months  | 13 to 36<br>Months  | More than<br>36<br>Months | Total           |
|--|--------------------|--------------------|--------------------|---------------------|---------------------------|-----------------|
| <b>Interest Rate Sensitive Assets</b>          |                    |                    |                    |                     |                           |                 |
| Loans (1)                                      |                    |                    |                    |                     |                           |                 |
| Fixed rate                                     | \$ 24,447          | \$ 15,295          | \$ 18,340          | \$ 33,651           | \$ 149,073                | \$ 240,806      |
| Variable rate                                  | 139,532            | 5,141              | 7,372              | 17,745              | 53,122                    | 222,912         |
| Investment securities                          | -                  | -                  | -                  | 2,347               | 39,021                    | 41,368          |
| Loans held for sale                            | 10,525             | -                  | -                  | -                   | -                         | 10,525          |
| Federal funds sold                             | 34,520             | -                  | -                  | -                   | -                         | 34,520          |
| <b>Total rate sensitive assets</b>             | <b>209,024</b>     | <b>20,436</b>      | <b>25,712</b>      | <b>53,743</b>       | <b>241,216</b>            | <b>550,131</b>  |
| <b>Cumulative rate sensitive assets</b>        | <b>209,024</b>     | <b>229,460</b>     | <b>255,172</b>     | <b>308,915</b>      | <b>550,131</b>            |                 |
| <b>Interest Rate Sensitive Liabilities</b>     |                    |                    |                    |                     |                           |                 |
| Interest checking (2)                          | -                  | -                  | -                  | 37,105              | -                         | 37,105          |
| Money market accounts                          | 105,830            | -                  | -                  | -                   | -                         | 105,830         |
| Savings (2)                                    | -                  | -                  | -                  | 9,985               | -                         | 9,985           |
| Certificates of deposit                        | 41,416             | 41,720             | 102,459            | 116,643             | 15,488                    | 317,726         |
| FHLB advances                                  | 15,000             | -                  | -                  | 10,000              | 4,000                     | 29,000          |
| Trust Preferred Securities                     | -                  | -                  | -                  | -                   | 8,764                     | 8,764           |
| Federal funds purchased                        | -                  | -                  | -                  | -                   | -                         | -               |
| Other borrowings                               | 4,611              | 41                 | 88                 | 537                 | 9,194                     | 14,471          |
| <b>Total rate sensitive liabilities</b>        | <b>166,857</b>     | <b>41,761</b>      | <b>102,547</b>     | <b>174,270</b>      | <b>37,446</b>             | <b>522,881</b>  |
| <b>Cumulative rate sensitive liabilities</b>   | <b>166,857</b>     | <b>208,618</b>     | <b>311,165</b>     | <b>485,435</b>      | <b>522,881</b>            |                 |
| <b>Rate sensitivity gap for period</b>         | <b>\$ 42,167</b>   | <b>\$ (21,325)</b> | <b>\$ (76,835)</b> | <b>\$ (120,527)</b> | <b>203,770</b>            | <b>\$27,250</b> |
| <b>Cumulative rate sensitivity gap</b>         | <b>\$ 42,167</b>   | <b>\$ 20,842</b>   | <b>\$ (55,993)</b> | <b>\$ (176,520)</b> | <b>27,250</b>             |                 |
| <b>Ratio of cumulative gap to total assets</b> | <b>6.9%</b>        | <b>3.4%</b>        | <b>(9.1)%</b>      | <b>(28.7)%</b>      | <b>4.4%</b>               |                 |

|  |        |        |         |         |        |
|--|--------|--------|---------|---------|--------|
| Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities | 125.3% | 110.0% | 82.0%   | 63.6%   | 105.2% |
| Ratio of cumulative gap to cumulative rate sensitive assets                        | 20.2%  | 9.1%   | (21.9)% | (57.1)% | 5.0%   |

(1) Includes nonaccrual loans of approximately \$33,251,000, which are spread throughout the categories.

(2) Management believes that interest checking and savings accounts are generally not sensitive to changes in interest rates and therefore has placed such deposits in the "13 to 36 months" category.

At March 31, 2010, our assets that reprice within six months exceeded liabilities that reprice within six months by \$20,842,000 and therefore we were in an asset positive position for that period. An asset positive position, or positive gap, can adversely affect earnings in periods of falling interest rates, but can improve earnings in periods of rising interest rates. Because of the current historic low interest rates adopted by the Federal Reserve, we believe interest rates can only increase from their current levels. Accordingly, we believe our current repricing posture should be asset sensitive. We have adopted pricing policies to lengthen the maturities/repricing of our liabilities relative to the maturities/pricing of our assets.

### Critical accounting policies

The accounting and reporting policies followed by the Company conform, in all material respects, to U.S. generally accepted accounting principles (“U.S. GAAP”) which, effective for all interim and annual periods ending after September 15, 2009, principally consist of the Financial Standards Board Accounting Standards Codification (“FASB Codification”). FASB Codification Topic 105: Generally Accepted Accounting Principles establishes the FASB codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the Securities and Exchange Commission (“SEC”) under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the FASB Codification carries an equal level of authority. All non-grandfathered, non SEC accounting literature not included in the FASB Codification is superseded and deemed non-authoritative. In preparing the consolidated financial statements, management has made estimates, assumptions and judgments based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements may reflect different estimates, assumptions and judgments. Certain policies inherently have greater reliance on the use of estimates, assumptions and judgments and, as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation allowance to be established, or when an asset or liability must be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when readily available. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, which management believes to be reasonable under the circumstances. The Company adjusts such estimates and assumptions when the Company believes facts and circumstances dictate. Illiquid credit markets, volatile equity, foreign currency and energy markets and declines in consumer spending have combined to increase the uncertainty inherent in such estimates and assumptions. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in those estimates resulting from continuing changes in the economic environment will be reflected in the financial statements in the future periods.

The financial condition and results of operations presented in the financial statements, accompanying notes to the financial statements and management's discussion and analysis are, to a large degree, dependent upon the Company's accounting policies. 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 accounting policies to the portrayal and understanding of our financial condition and results of operations. These 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. See also Note 1 of the Notes to Consolidated Financial Statements filed with the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

#### Allowance for loan losses

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses

inherent in the loan portfolio. We maintain 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 they 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 allowance reflects management's best estimate of probable losses within the existing loan portfolio and of the risk inherent in various components of the loan portfolio, including loans identified as impaired as required by FASB Codification Topic 310: Receivables. 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.

Loans are grouped by similar characteristics, including the type of loan, the assigned loan classification 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 is adjusted for relevant environmental factors and other conditions of the portfolio of loans and leases, 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 our allowance for loan losses 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. We recognize the inherent imprecision in estimates of losses due to various uncertainties and variability related to the factors used, and therefore a reasonable range around the estimate of losses is derived and used to ascertain whether the allowance is too high. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the financial statements.

#### Loans held for sale

The Company, through the Bank's mortgage banking subsidiary, Village Bank Mortgage, originates residential mortgage loans for sale in the secondary market. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an aggregate basis as determined by outstanding commitments from investors. Upon entering into a commitment to originate a loan, the Company locks in the loan and rate with an investor and commits to deliver the loan if settlement occurs on a best efforts basis, thus limiting interest rate risk. Certain additional risks exist that the investor fails to meet its purchase obligation, however, based on historical performance and the size and nature of the investors the company does not expect them to fail to meet their obligation. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Residential mortgage loans held for sale are sold to the permanent investor with the mortgage servicing rights released. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold. This difference arises primarily as a result of the value of the mortgage servicing rights.

Once a residential mortgage loan is sold to a permanent investor, the Company has no further involvement or retained interest in the loan. There are limited circumstances in which the permanent investor can contractually require the Company to repurchase the loan. The Company makes no provision for any such recourse related to loans sold as history has shown repurchase of loans under these circumstances has been remote.

#### Income taxes

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Deferred taxes are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Management is also required to identify, estimate and disclose positions they have taken where the income tax treatment of the position taken is not 100% certain. Our evaluation of the deductibility or taxability of items included in the Company's tax returns has not resulted in the identification of any material, uncertain tax positions.

#### Impact of inflation and changing prices and seasonality

The Company's financial statements included herein have been prepared in accordance with generally accepted accounting principles in the United States, which require the Company to measure financial position and operating results primarily in terms of historical dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Company is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Company, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable.

ITEM 4T – CONTROLS AND PROCEDURES

Based upon an evaluation as of March 31, 2010 under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer of the effectiveness of the design and operation of the Company's disclosure controls and procedures, they have concluded that our disclosure controls and procedures, as defined in Rule 13a-15 and Rule 15d-15 under the Securities Exchange Act of 1934, as amended, are effective in ensuring that all material information required to be disclosed in reports that it files or submits under such Act is recorded, processed, summarized and is made known to management in a timely fashion.

Our management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in our internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company'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

Not applicable.

ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4 – REMOVED AND RESERVED

ITEM 5 – OTHER INFORMATION

Not applicable.

ITEM 6 – EXHIBITS

31.1 Certification of Chief Executive Officer

31.2 Certification of Chief Financial Officer

32.1 Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350



SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

VILLAGE BANK AND TRUST FINANCIAL CORP.  
(Registrant)

Date: May 14, 2010  
Thomas W. Winfree  
President and  
Chief Executive Officer

By: /s/ Thomas W. Winfree

Date: May 14, 2010  
C. Harril Whitehurst, Jr.  
Senior Vice President and  
Chief Financial Officer

By: /s/ C. Harril Whitehurst, Jr.

EXHIBIT INDEX

| Number | Exhibit<br>Document  |
|--------|--|
| 31.1   | Certification of Chief Executive Officer   |
| 31.2   | Certification of Chief Financial Officer   |
| 32.1   | Statement of Chief Executive Officer and Chief Financial Officer<br>Pursuant to 18 U.S.C. Section 1350 |

