

Village Bank & Trust Financial Corp.  
Form 10-Q  
November 14, 2011

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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 September 30, 2011

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 23113  
(Address of principal executive offices)

(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

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  (Do not check if 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.

4,243,378 shares of common stock, \$4.00 par value, outstanding as of November 3, 2011

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## PART I – FINANCIAL INFORMATION

## ITEM 1 – FINANCIAL STATEMENTS

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Balance Sheets  
September 30, 2011 (Unaudited) and December 31, 2010

	September 30, 2011	December 31, 2010
<b>Assets</b>		
Cash and due from banks	\$47,964,169	\$9,390,377
Federal funds sold	5,787,193	2,621,934
Total cash and cash equivalents	53,751,362	12,012,311
Investment securities available for sale	56,691,242	53,597,174
Loans held for sale	13,786,238	19,871,787
<b>Loans</b>		
Outstandings	436,063,963	453,242,950
Allowance for loan losses	(14,962,062 )	(7,311,712 )
Deferred fees and costs	729,040	623,851
	421,830,941	446,555,089
Premises and equipment, net	27,106,734	27,437,452
Accrued interest receivable	2,360,571	2,347,211
Bank owned life insurance	6,019,164	5,871,765
Other real estate owned	8,937,045	12,028,111
Other assets	15,357,786	12,058,315
	<b>\$605,841,083</b>	<b>\$591,779,215</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest bearing demand	\$62,865,964	\$41,036,262
Interest bearing	441,305,236	457,975,931
Total deposits	504,171,200	499,012,193
Long-term debt - trust preferred securities	8,764,000	8,764,000
Federal Home Loan Bank advances	37,750,000	28,750,000
Other borrowings	5,107,402	4,165,430
Accrued interest payable	514,280	404,801
Other liabilities	5,537,305	2,362,597
Total liabilities	561,844,187	543,459,021
<b>Stockholders' equity</b>		
Preferred stock, \$4 par value, \$1,000 liquidation preference, 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 4,243,378 shares issued and outstanding at September 30, 2011 4,238,416 shares issued and outstanding at December 31, 2011	16,973,512	16,953,664

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Additional paid-in capital	40,702,568	40,633,581
Retained earnings (deficit)	(14,758,254 )	(9,192,552 )
Common stock warrant	732,479	732,479
Discount on preferred stock	(383,108 )	(492,456 )
Accumulated other comprehensive income (loss)	670,747	(373,474 )
Total stockholders' equity	43,996,896	48,320,194
	\$605,841,083	\$591,779,215

See accompanying notes to consolidated financial statements

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Income  
Three and Nine Months Ended September 30, 2011 and 2010  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest income				
Loans	\$6,586,170	\$7,409,474	\$20,394,359	\$21,713,276
Investment securities	356,893	237,059	1,010,017	879,976
Federal funds sold	19,464	13,747	58,268	43,983
Total interest income	6,962,527	7,660,280	21,462,644	22,637,235
Interest expense				
Deposits	1,693,205	2,168,903	5,638,873	6,958,389
Borrowed funds	305,307	450,301	885,156	1,520,365
Total interest expense	1,998,512	2,619,204	6,524,029	8,478,754
Net interest income	4,964,015	5,041,076	14,938,615	14,158,481
Provision for loan losses	9,507,884	1,410,000	11,410,884	3,150,000
Net interest income after provision for loan losses	(4,543,869)	3,631,076	3,527,731	11,008,481
Noninterest income				
Service charges and fees	495,165	484,981	1,366,547	1,375,554
Gain on sale of loans	1,724,730	1,922,868	4,733,648	4,761,092
Gain (loss) on sale of assets	108,473	-	171,617	840,941
Rental income	168,311	118,515	484,540	387,457
Other	100,804	136,111	303,348	494,196
Total noninterest income	2,597,483	2,662,475	7,059,700	7,859,240
Noninterest expense				
Salaries and benefits	3,060,285	3,180,292	9,305,684	8,934,796
Occupancy	540,929	492,012	1,552,537	1,529,597
Equipment	224,334	192,505	668,554	631,619
Supplies	98,621	111,941	324,565	363,127
Professional and outside services	599,893	460,308	1,689,339	1,476,927
Advertising and marketing	84,740	109,584	319,163	335,244
Expenses related to foreclosed real estate	387,666	327,261	1,211,878	1,008,597
Other operating expenses	973,426	913,419	2,850,734	2,645,798
Total noninterest expense	5,969,894	5,787,322	17,922,454	16,925,705
Net income before income taxes	(7,916,280)	506,229	(7,335,023 )	1,942,016
Income tax expense (benefit)	(2,671,535)	172,117	(2,429,829 )	660,285
Net income (loss)	(5,244,745)	334,112	(4,905,194 )	1,281,731

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Preferred stock dividends and amortization of discount	222,281	221,910	660,508	659,399
Net income (loss) available to common shareholders	\$(5,467,026)	\$112,202	\$(5,565,702)	\$622,332
Earnings (loss) per share, basic	\$(1.29	) \$0.03	\$(1.31	) \$0.15
Earnings (loss) per share, diluted	\$(1.29	) \$0.03	\$(1.31	) \$0.15

See accompanying notes to consolidated financial statements



Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Stockholders' Equity  
and Comprehensive Income  
Nine Months Ended September 30, 2011 and 2010  
(Unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Warrant	Accumulated		Total
						Discount on Preferred Stock	Other Comprehensive Income (loss)	
Balance, December 31, 2005		7,418,472	9,191,567	585,416			(43,562 )	17,151,893
Issuance of common stock		2,829,880	4,374,314	-			-	7,204,194
Stock based compensation		-	23,007	-			-	23,007
Minimum pension adjustment (net of income taxes of Balance, December 31, 2010	\$58,952	\$16,953,664	\$40,633,581	\$(9,192,552 )	\$732,479	\$(492,456)	\$(373,474 )	\$48,320,194
Amortization of preferred stock discount	-			(109,348 )	-	109,348	-	-
Preferred stock dividend	-	-		(551,160 )	-	-	-	(551,160 )
Issuance of common stock	-	19,848	(19,848 )	-	-	-	-	-
Stock based compensation			88,835					88,835
Minimum pension adjustment (net of income taxes of \$3,315)	-	-	-	-	-	-	6,435	6,435
Net income (loss)	-	-	-	(4,905,194 )	-	-	-	(4,905,194 )
Change in unrealized gain on investment securities available-for-sale, net of reclassification	-	-	-	-	-	-	1,037,786	1,037,786

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and tax effect								
Total								
comprehensive								
income	-	-	-	-	-	-	-	(3,860,973 )
Balance,								
September 30,								
2011	\$58,952	\$16,973,512	\$40,702,568	\$(14,758,254)	\$732,479	\$(383,108)	\$670,747	\$43,996,896
Balance,								
December 31,								
2009	\$58,952	\$16,922,512	\$40,568,771	\$(9,741,459 )	\$732,479	\$(636,959)	\$(56,205 )	\$47,848,091
Amortization of								
preferred stock								
discount	-	-		(108,239 )	-	108,239	-	-
Preferred stock								
dividend	-	-		(551,160 )	-	-	-	(551,160 )
Issuance of								
common stock	-	31,152	(31,152 )	-	-	-	-	-
Stock based								
compensation			73,072					73,072
Minimum pension								
adjustment								-
(net of income								
taxes of \$2,188)	-	-	-	-	-	-	6,435	6,435
Net income	-	-	-	1,281,731	-	-	-	1,281,731
Change in								
unrealized gain on								
investment								
securities								
available-for-sale,								
net of								
reclassification								
and tax effect	-	-	-	-	-	-	297,440	297,440
Total								
comprehensive								
income	-	-	-	-	-	-	-	1,585,606
Balance,								
September 30,								
2010	\$58,952	\$16,953,664	\$40,610,691	\$(9,119,127 )	\$732,479	\$(528,720)	\$247,670	\$48,955,609

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Cash Flows  
Nine Months Ended September 30, 2011 and 2010  
(Unaudited)

	2011	2010
Cash Flows from Operating Activities		
Net income (loss)	\$(4,905,194 )	\$1,281,731
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,065,855	976,201
Deferred income taxes	(3,710,085 )	-
Provision for loan losses	11,410,884	3,150,000
Write-down of other real estate owned	546,331	184,000
Gain on securities sold	(172,994 )	(597,375 )
Gain on loans sold	(4,733,648 )	(4,761,092 )
Gain loss on sale of premises and equipment	-	(242,936 )
(Gain) loss on sale of other real estate owned	239,532	(17,546 )
Stock compensation expense	88,835	73,072
Proceeds from sale of other real estate owned	5,155,942	4,032,682
Proceeds from sale of mortgage loans	175,498,993	192,149,659
Origination of mortgage loans for sale	(164,679,796)	(206,404,127)
Amortization of premiums and accretion of discounts on securities, net	106,229	367,149
(Increase) decrease in interest receivable	(13,360 )	775,417
Increase in bank owned life insurance	(147,399 )	(392,312 )
(Increase) decrease in other assets	(117,566 )	1,485,722
Increase (decrease) in interest payable	109,479	(69,225 )
Increase (decrease) in other liabilities	3,174,706	(625,450 )
Net cash provided by (used in) operating activities	18,916,744	(8,634,430 )
Cash Flows from Investing Activities		
Purchases of available for sale securities	(76,141,951 )	(15,138,493 )
Proceeds from the sale or calls of available for sale securities	803,100	40,670,661
Proceeds from maturities and principal payments of available for sale securities	73,883,951	1,694,167
Net decrease (increase) in loans	10,462,525	(775,672 )
Purchases of premises and equipment	(735,137 )	(863,782 )
Proceeds from sale of premises and equipment	-	377,321
Net cash provided by investing activities	8,272,488	25,964,202
Cash Flows from Financing Activities		
Net increase in deposits	5,159,007	(8,232,051 )
Net increase (decrease) in Federal Home Loan Bank Advances	9,000,000	(250,000 )
Net increase (decrease) in other borrowings	941,972	(10,045,070 )
Dividends on preferred stock	(551,160 )	(551,160 )
Net cash provided by (used in) financing activities	14,549,819	(19,078,281 )
Net increase (decrease) in cash and cash equivalents	41,739,051	(1,748,509 )
Cash and cash equivalents, beginning of period	12,012,311	20,661,820

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Cash and cash equivalents, end of period	\$53,751,362	\$18,913,311
Supplemental Schedule of Non Cash Activities		
Real estate owned assets acquired in settlement of loans	\$2,714,621	\$5,861,491

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, 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 and nine month periods ended September 30, 2011 are not necessarily indicative of the results to be expected for the full year ending December 31, 2011. 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, 2010 as filed with the Securities and Exchange Commission.

Note 2 - Use of estimates

The preparation of 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 balance sheets and statements of income for the 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:

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	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
<b>Numerator</b>				
Net income (loss) - basic and diluted	\$(5,244,745)	\$334,112	\$(4,905,194)	\$1,281,731
Preferred stock dividend and accretion	222,281	221,910	660,508	659,399
Net income (loss) available to common shareholders	\$(5,467,026)	\$112,202	\$(5,565,702)	\$622,332
<b>Denominator</b>				
Weighted average shares outstanding - basic	4,243,378	4,238,416	4,242,905	4,237,505
Dilutive effect of common stock options and restricted stock awards	-	-	-	-
Weighted average shares outstanding - diluted	4,243,378	4,238,416	4,242,905	4,237,505
<b>Earnings (loss) per share - basic and diluted</b>				
Earnings (loss) per share - basic	\$(1.29 )	\$0.03	\$(1.31 )	\$0.15
Effect of dilutive common stock options	-	-	-	-
Earnings (loss) per share - diluted	\$(1.29 )	\$0.03	\$(1.31 )	\$0.15

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 310,205 shares of common stock were not included in computing diluted earnings per share for the three and nine months ended September 30, 2011 and 2010 because their effects were anti-dilutive. Warrants to acquire 499,029 shares of common stock were not included in computing earnings per share in 2011 and 2010 because their effects were also anti-dilutive.

Note 4 – Loans and Allowance for Loan Losses

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

	September 30, 2011			December 31, 2010		
	Amount	%		Amount	%	
Commercial	\$37,961,852	8.7	%	\$37,227,599	8.2	%
Real estate - Construction, land development & other loans	86,467,444	19.8	%	90,773,214	20.0	%
Real estate - Commercial	166,807,984	38.3	%	173,227,491	38.2	%
Real estate - 1-4 Residential	140,034,966	32.1	%	146,646,780	32.4	%
Consumer	4,791,717	1.1	%	5,367,866	1.2	%
Total loans	436,063,963	100.0	%	453,242,950	100.0	%
Deferred loan cost (unearned income), net	729,040			623,851		
Less: Allowance for loan losses	(14,962,062 )			(7,311,712 )		

\$421,830,941

\$446,555,089

The Company assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

- Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. 1-4 assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
  - Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;
- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any, and;
- Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

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The following tables provide information on the risk rating of loans at the dates indicated.

	September 30, 2011				Total Loans
	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	
Commercial	\$ 33,335,341	\$ 1,581,393	\$ 2,600,679	\$ 444,439	\$ 37,961,852
Real estate - construction, land development and other loans	53,953,677	4,743,187	27,770,580	-	86,467,444
Real estate - commercial	98,128,635	21,906,607	46,459,498	313,244	166,807,984
Real estate - 1-4 residential	120,080,357	9,293,980	10,602,621	58,008	140,034,966
Consumer	3,509,806	678,697	464,006	139,208	4,791,717
	\$ 309,007,816	\$ 38,203,864	\$ 87,897,384	\$ 954,899	\$ 436,063,963

	December 31, 2010				Total Loans
	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	
Commercial	\$25,320,711	\$2,577,779	\$3,283,334	\$524,415	\$31,706,239
Real estate - construction, land development and other loans	17,132,832	3,438,546	24,648,900	-	45,220,278
Real estate - commercial	212,375,139	20,391,192	28,557,575	193,251	261,517,157
Real estate - 1-4 residential	87,598,976	5,717,843	9,904,670	163,825	103,385,314
Consumer	10,383,486	623,556	299,191	107,729	11,413,962
	\$352,811,144	\$32,748,916	\$66,693,670	\$989,220	\$453,242,950

The following table presents the aging of the recorded investment in past due loans at the dates indicated.

	September 30, 2011					Total Loans	Recorded Investment > 90 Days and Accruing
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current		
Commercial	\$52,401	\$72,666	\$11,558	\$136,625	\$37,825,227	\$37,961,852	\$11,558
Real estate - construction, land development and other loans	569,219 694,707	991,594 2,645,910	- 71,620	1,560,813 3,412,237	84,906,631 163,395,747	86,467,444 166,807,984	- 71,620



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Real estate -  
commercial

Real estate - 1-4

residential

Consumer

1,012,321	2,254,390	18,700	3,285,411	136,749,555	140,034,966	18,700
136,830	2,992	-	139,822	4,651,895	4,791,717	-
\$2,465,478	\$5,967,552	\$101,878	\$8,534,908	\$427,529,055	\$436,063,963	\$101,878

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December 31, 2010

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial Real estate - construction, land development and other loans	\$ 190,585	\$ 501,378	\$ -	\$ 691,963	\$ 31,014,276	\$ 31,706,239	\$ -
Real estate - 1-4 residential	5,515,931	673,204	79,343	6,268,478	300,468,956	306,737,434	79,343
Consumer	2,672,157	973,269	213,478	3,858,904	99,526,410	103,385,314	213,478
	149,804	42,645	22,322	214,771	11,199,192	11,413,963	22,322
	\$ 8,528,477	\$ 2,190,496	\$ 315,143	\$ 11,034,116	\$ 442,208,834	\$ 453,242,950	\$ 315,143

Loans are considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Impaired loans at the dates indicated are set forth in the following table.

September 30, 2011

Recorded Investment

Description of Loans	Unpaid Contractual Principal Balance	Total Recorded Investment	Recorded Investment with Allowance	Recorded Investment with No Allowance	Related Allowance	Recorded Average Investment
Commercial Real estate - construction, land development and other loans	\$282,900	\$282,900	\$-	\$282,900	\$-	\$1,568,978
Real estate - commercial	21,685,177	16,877,409	7,391,025	9,486,384	4,807,768	21,691,733
Real estate - 1-4 residential	21,085,849	18,794,889	11,457,440	7,337,449	2,290,960	8,200,227
Consumer	17,601,256	15,822,156	3,495,098	12,327,058	1,779,100	12,905,229
	493,341	493,341	-	493,341	-	292,430

\$61,148,523   \$52,270,695   \$22,343,563   \$29,927,132   \$8,877,828   \$44,658,597

Description of Loans	December 30, 2010						
	Unpaid Contractual Principal Balance	Recorded Investment			Recorded Investment with No Allowance	Related Allowance	Recorded Average Investment
		Total Recorded Investment	Recorded Investment with Allowance	Recorded Investment with No Allowance			
Commercial	\$ 3,642,820	\$ 3,401,381	\$ 178,320	\$ 3,223,061	\$ 178,320	\$ 3,755,382	
Real estate - construction, land development and other loans	15,439,512	10,914,812	1,476,524	9,438,288	110,000	16,182,175	
Real estate - 1-4 residential	6,122,804	5,728,804	59,622	5,669,182	16,500	6,924,937	
Consumer	278,890	278,890	-	278,890	-	288,539	
	\$ 25,484,026	\$ 20,323,887	\$ 1,714,466	\$ 18,609,421	\$ 304,820	\$ 27,151,032	

Included in impaired loans are loans classified as troubled debt restructurings (TDRs). A modification of a loan's terms constitutes a TDR if the creditor grants a concession to the borrower for economic or legal reasons related to the borrower's financial difficulties that it would not otherwise consider. As a result of adopting the amendments in Accounting Standards

Update 2011-02, the Company reassessed all loan modifications that occurred since January 1, 2011 for identification as TDRs. There were no additional TDRs identified in this reassessment. For loans classified as impaired TDRs, the Company further evaluates the loans as performing or nonperforming. If, at the time of restructure, the loan is not considered nonaccrual, it will be classified as performing. TDRs originally classified as nonperforming are able to be reclassified as performing if, subsequent to restructure, they experience six months of payment performance according to the restructured terms. The following table provides certain information concerning TDRs as of September 30, 2011.

	Total	Performing	Nonaccrual	Past Due 31-89 Days	Specific Valuation Allowance
Real estate - Construction, land development & other loans	\$20,272,438	\$12,335,555	\$7,936,883	\$-	\$4,502,948
Real estate - Commercial	6,159,152	3,978,436	-	2,180,716	304,300
Real estate - 1-4 Residential	5,575,961	5,575,961	-	-	404,000
	\$32,007,551	\$21,889,952	\$7,936,883	\$2,180,716	\$5,211,248
Number of loans	39	29	9	1	12

Interest income recorded on performing TDRs is presented in the following table.

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Real estate - Construction, land development & other loans	\$ 212,740	\$ 638,220
Real estate - Commercial	86,908	260,724
Real estate - 1-4 Residential	45,698	137,093
	\$ 345,346	\$ 1,036,037

The following table provides information about TDRs identified during the current period.

Number of Loans	Three Months Ended September 30, 2011		Number of Loans	Nine Months Ended September 30, 2011	
	Pre- Modification Recorded Balance	Post- Modification Recorded Balance		Pre- Modification Recorded Balance	Post- Modification Recorded Balance

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New TDRs

Real estate - Construction, land development & other loans	4	\$ 3,015,029	\$ 3,015,029	8	\$ 5,855,511	\$ 5,855,511
Real estate - Commercial	2	2,414,805	2,414,805	3	3,190,261	3,190,261
Real estate - 1-4 Residential	2	1,422,772	1,422,772	2	1,422,772	1,422,772
	8	\$ 6,852,606	\$ 6,852,606	13	\$ 10,468,544	\$ 10,468,544

Defaults on TDRs

Real estate - Construction, land development & other loans	6	\$ 6,182,810		12	\$ 11,835,296	
Real estate - Commercial	1	2,180,716		1	2,180,716	
	7	\$ 8,363,526		13	\$ 14,016,012	

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The Company's recorded investment in loans as of September 30, 2011 related to each balance in the allowance for possible loan losses by portfolio segment and disaggregated on the basis of the Company's impairment methodology as follows:

	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total
Commercial	\$ 14,828,282	\$ 23,258,515	\$ 38,086,797
Real estate - Construction, land development & other loans	33,571,308	52,702,885	86,274,193
Real estate - Commercial	144,051,981	22,871,350	166,923,331
Real estate - 1-4 Residential	16,148,913	123,435,302	139,584,215
Consumer	3,976,796	1,218,631	5,195,427
	\$ 212,577,280	\$ 223,486,683	\$ 436,063,963

Activity in the allowance for loan losses is as follows:

	Commercial	Real estate construction, land development and other	Real estate commercial	Real estate 1-4 residential	Consumer	Total
Balance June 30, 2011	\$1,250,929	\$ 3,575,106	\$108,215	\$1,884,733	\$437,631	\$7,256,614
Charge-offs	(1,042,622)	(193,251 )	-	(483,399 )	(93,415 )	(1,812,687 )
Recoveries	-	8,750	-	211	1,290	10,251
Provision	488,209	4,263,747	2,392,867	2,286,693	76,368	9,507,884
Balance September 30, 2011	\$696,516	\$ 7,654,352	\$2,501,082	\$3,688,238	\$421,874	\$14,962,062
Balance December 31, 2010	\$1,315,582	\$ 3,125,960	\$98,921	\$2,342,583	\$428,665	\$7,311,712
Charge-offs	(1,635,256)	(193,251 )	(326,803 )	(1,442,376)	(186,886 )	(3,784,573 )
Recoveries	2,000	18,750	-	1,557	1,732	24,039
Provision	1,014,190	4,702,893	2,728,964	2,786,474	178,363	11,410,884
Balance September 30, 2011	\$696,516	\$ 7,654,352	\$2,501,082	\$3,688,238	\$421,874	\$14,962,062

The following table summarizes asset quality information at the dates indicated.

Asset Quality (in thousands)		September 30, 2011	December 31, 2010
Nonaccrual loans	\$	26,643	\$ 20,324
Foreclosed properties		8,937	12,028
Total nonperforming assets	\$	35,580	\$ 32,352
Restructured loans	\$	32,008	\$ 21,695
Loans past due 90 days and still accruing (not included in nonaccrual loans above)	\$	102	\$ 315
Nonperforming assets to loans at end of period(1)		8.16 %	7.14 %
Nonperforming assets to total assets		5.87 %	5.47 %
Allowance for loan losses to nonaccrual loans		56.2 %	36.0 %

(1) Loans are net of unearned income.

The following table presents an analysis of the changes in nonperforming assets for the dates indicated.

Nonperforming Assets (In thousands)			
	Nonaccrual Loans	Foreclosed Properties	Total
Balance December 31, 2009	\$ 25,913	\$ 11,279	\$ 37,192
Additions, net	10,094	481	10,575
Sales	-	(6,020 )	(6,020 )
Transfers	(6,717 )	6,717	-
Repayments	(600 )	-	(600 )
Charge-offs	(8,366 )	(429 )	(8,795 )
Balance December 31, 2010	\$ 20,324	\$ 12,028	\$ 32,352
Additions, net	13,778	136	13,914
Sales	-	(5,396 )	(5,396 )
Transfers	(2,715 )	2,715	-

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Repayments	(967 )	-	(967 )
Charge-offs	(3,777 )	(546 )	(4,323 )
Balance September 30, 2011	\$ 26,643	\$ 8,937	\$ 35,580



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Note 5 – Investment securities

At September 30, 2011 and December 31, 2010, all of our securities were classified as available-for-sale. The following table presents the composition of our investment portfolio at the dates indicated (dollars in thousands).

	Par Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Average Yield	
September 30, 2011							
US Government Agencies							
Five to ten years	\$2,775	\$2,775	\$20	\$-	\$2,795	3.22	%
Mortgage-backed securities							
One to five years	72	74	-	-	74	2.68	%
More than ten years	40,169	41,111	873	(32)	41,952	2.46	%
Total	40,241	41,185	873	(32)	42,026	2.46	%
Municipals							
More than ten years	4,000	4,084	314	-	4,398	5.14	%
Other investments							
More than ten years	7,442	7,472	10	(10)	7,472	0.52	%
Total investment securities	\$54,458	\$55,516	\$1,217	\$(42)	\$56,691	2.45	%
December 31, 2010							
US Treasuries							
One to five years	\$28,000	\$28,017	\$-	\$-	\$28,017	0.22	%
US Government Agencies							
Five to ten years	3,000	3,000		(111)	2,889	2.00	%
Mortgage-backed securities							
One to five years	686	703	31	(10)	724	4.90	%
More than ten years	14,410	14,796	91	(58)	14,829	2.86	%
Total	15,096	15,499	122	(68)	15,553	5.39	%
Municipals							
More than ten years	6,000	6,060	-	(337)	5,723	4.69	%
Other investments							
More than ten years	1,418	1,418	-	(3)	1,415	0.69	%
Total investment securities	\$53,514	\$53,994	\$122	\$(519)	\$53,597	2.31	%

Investment securities available for sale that have an unrealized loss position at September 30, 2011 and December 31, 2010 are detailed below.



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	Securities in a loss Position for less than 12 Months		Securities in a loss Position for more than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value (Loss)	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2011						
Investment Securities available for sale						
Mortgage-backed securities	\$4,834	\$(31 )	\$270	\$(1 )	\$5,104	\$(32 )
Municipals	3,965	(10 )	-	-	3,965	(10 )
Total	\$8,799	\$(41 )	\$270	\$(1 )	\$9,069	\$(42 )
December 31, 2010						
Investment Securities available for sale						
US Treasuries	\$30,286	\$(114 )	\$-	\$-	\$30,286	\$(114 )
Mortgage-backed securities	7,079	(68 )	-	-	7,079	(68 )
Municipals	5,723	(337 )	-	-	5,723	(337 )
Total	\$43,088	\$(519 )	\$-	\$-	\$43,088	\$(519 )

Management does not believe that any individual unrealized loss as of September 30, 2011 and December 31, 2010 is other than a temporary impairment. These unrealized losses are primarily attributable to changes in interest rates. As of September 30, 2011, management does not have the intent to sell any of the securities classified as available for sale and management believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

Note 6 – Deposits

Deposits as of September 30, 2011 and December 31, 2010 were as follows:

	September 30, 2011		December 31, 2010	
	Amount	%	Amount	%
Noninterest bearing demand	\$ 62,865,964	12.47 %	\$ 41,036,262	8.22 %
Interest checking accounts	39,356,483	7.81 %	33,291,777	6.67 %
Money market accounts	83,742,862	16.61 %	90,156,362	18.07 %
Savings accounts	13,561,520	2.69 %	10,538,023	2.11 %
Time deposits of \$100,000 and over	126,429,092	25.08 %	140,846,619	28.23 %
Other time deposits	178,215,279	35.35 %	183,143,150	36.70 %

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Total	\$ 504,171,200	100.00 %	\$ 499,012,193	100.00 %
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Note 7 – 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 September 30, 2011 was 2.40%. The securities were redeemable at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. No amounts have been redeemed at September 30, 2011 and there are no plans to do so. 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. In consideration of the Company's Memorandum of Understanding with the Federal Reserve Bank of Richmond, which requires regulatory approval to make interest payments on these securities, the Company elected to defer interest payments on the junior subordinated debt securities of \$89,135 due on June 15, 2011, and \$89,135 due on September 15, 2011. We also anticipate deferring interest payments of approximately \$89,000 due December 15, 2011. Although we elected to defer payment of the interest due, the amount has been accrued and is included in interest expense.

#### Note 8 – 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:

	Nine Months Ended September 30,							
	2011				2010			
	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	310,205	\$9.48	\$4.73		336,005	\$9.58	\$4.75	
Granted	-	-	-		-	-	-	
Forfeited	-	-	-		(25,800 )	10.77	5.02	
Exercised	-	-	-		-	-	-	
Options outstanding, end of period	310,205	\$9.48	\$4.73	\$-	310,205	\$9.48	\$4.73	\$-

Options exercisable, end of period	291,350	291,350
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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 6,271 and 14,881 at September 30, 2011 and 2010, respectively.

The fair value of the stock is calculated under the same methodology as stock options and the expense is recognized over the vesting period. Unamortized stock-based compensation related to nonvested share based compensation arrangements granted under the Incentive Plan as of September 30, 2011 and 2010 was \$35,960 and \$170,568, respectively. The time based unamortized compensation of \$35,960 is expected to be recognized over a weighted average period of 0.35 years.

Stock-based compensation expense was \$88,835 and \$73,072 for the nine months ended September 30, 2011 and 2010, respectively.

#### Note 9 — 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 held-to-maturity and available-for-sale is estimated based on quoted prices for similar assets or liabilities determined by bid quotation received from independent pricing services (Levels 1 and 2).

Residential loans held for sale: The fair value of loans held for sale is determined using quoted prices for a similar asset, adjusted for specific attributes of that loan (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 vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than two years old, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal if deemed significant using observable market data. Likewise, values for inventory and account receivables collateral are based on financial statement balances or aging reports (Level 3). Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

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.

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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 Value	Fair Value Measurement at September 30, 2011 Using 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	\$ 2,795	\$ -	\$ 2,795	\$ -
MBS	42,026	-	42,026	-
Municipals	4,398	-	4,398	-
Other available for sale(1)	7,472	7,472	-	-
Financial Assets - Non-Recurring				
Impaired loans	47,852	-	31,221	16,631
Real estate owned	8,937	-	-	8,937
Residential loans held for sale	13,786	-	13,786	-
Fair Value Measurement at September 30, 2010 Using Quoted Prices				
	Carrying Value	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	\$ 8,854	\$ -	\$ 8,854	\$ -
MBS	12,125	-	12,125	-
Municipals	5,285	-	5,285	-
Other available for sale(1)	2,048	-	2,048	-
Financial Assets - Non-Recurring				
Impaired loans	23,943	-	-	23,943
Real estate owned	12,941	-	-	12,941
Residential loans held for sale	26,522	-	26,522	-



(1) Excludes restricted stock.

Fair Value Measurement - Level 3  
September 30, 2011

	Impaired Loans	Real Estate Owned (In thousands)	Total Assets
Balance at June 30, 2011	\$ 17,901	\$ 11,982	\$ 29,883
Total realized and unrealized gains (losses) included in earnings	(6,743 )	(172 )	(6,915 )
Net transfers in and/or out of Level 3	36,694	(2,873 )	33,821
Balance at September 30, 2011	\$ 47,852	\$ 8,937	\$ 56,789
Balance at December 31, 2010	\$ 8,662	\$ 12,028	\$ 20,690
Total realized and unrealized gains (losses) included in earnings	(8,646 )	(786 )	(9,432 )
Net transfers in and/or out of Level 3	47,836	(2,305 )	45,531
Balance at September 30, 2011	\$ 47,852	\$ 8,937	\$ 56,789

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.

	September 30, 2011		December 31, 2010	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial assets				
Cash and cash equivalents	\$ 53,751,362	\$ 53,751,362	\$ 12,012,311	\$ 12,012,311
Investment securities available for sale	56,691,242	56,691,242	53,597,174	53,597,174
Loans held for sale	13,786,238	13,786,238	19,871,787	19,871,787
Loans	421,830,941	424,278,543	446,555,089	451,155,101
Accrued interest receivable	2,360,571	2,360,571	2,347,211	2,347,211
Financial liabilities				
Deposits	504,171,200	506,120,173	499,012,193	501,222,836
FHLB borrowings	37,750,000	38,018,506	28,750,000	28,883,669
Trust preferred securities	8,764,000	8,764,000	8,764,000	8,764,000
Other borrowings	5,107,402	5,107,402	4,165,430	4,165,430
Accrued interest payable	514,280	514,280	404,801	404,801

#### Note 10 – 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 pays 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.

In consideration of the Company's Memorandum of Understanding with the Federal Reserve Bank of Richmond, the Company notified the U.S. Treasury in May 2011 that the Company was going to defer the payment of the quarterly cash dividend of \$184,225 due on May 16, 2011, and subsequent quarterly payments, on the Fixed Rate Cumulative Perpetual Preferred Stock, Series A. The total arrearage on such preferred stock as of the date of this filing is \$464,458.

#### Note 11 – Commitments and contingencies

Memorandums of Understanding – In December 2010, the Bank entered into a Memorandum of Understanding with the Federal Deposit Insurance Corporation (“FDIC”) and the Virginia Bureau of Financial Institutions (the “BFI”); in February 2011, the Company entered into an additional Memorandum of Understanding with the Federal Reserve and the BFI. Among other things, the Memorandums of Understanding require us to develop and submit plans to reduce improve our loan portfolio, reducing our commercial real estate concentration, maintain an appropriate allowance for loan losses, review our management performance, and correct certain violations of law. In particular, the Company must take corrective action regarding the Company's sale of its headquarters building at the Watkins Centre to the Bank, which the Reserve Bank has determined was not permitted under Section 23A of the Federal Reserve Act. This transaction had allowed the Company to repay the outstanding mortgage loan on the building, thereby reducing interest expense and increasing earnings on a consolidated basis; as a result, any corrective action could have an adverse impact on the Company's results of operations. The Company is seeking proposals for purchase of the building but has not received any as of the date of filing this report. In addition, the Memorandums of Understanding require us to limit asset growth to no more than 5% per year and maintain certain capital ratios higher than those required to be considered “well capitalized.” The Company has also agreed not to declare or pay any dividends on common stock or preferred stock, including the TARP preferred, or make any payments on its trust preferred securities, without prior regulatory approval.

While subject to the Memorandums of Understanding, we expect that our management and board of directors will be required to focus considerable time and attention on taking corrective actions to comply with the terms. In addition, certain provisions of the Memorandums of Understanding described above could adversely impact the Company's businesses and results of operations.

There is also no guarantee that we will successfully address our regulators' concerns in the Memorandums of Understanding or that we will be able to comply with it. If we do not comply with the Memorandums of Understanding, we could be subject to further regulatory enforcement actions.

As a result of an examination performed by the FDIC in the first quarter of 2011, the Bank expects to enter into a Consent Order with the FDIC in the fourth quarter of 2011. We are currently in discussions with the FDIC concerning the content of the Consent Order and do not know its exact requirements at this time. We believe, however, that those requirements, once finalized, will be more restrictive than those currently contained in the Bank's Memorandum of Understanding with the FDIC. In particular, we expect that, among other things, the Consent Order could require an evaluation of management, new capital requirements, restrictions on asset growth, limitations on our ability to use brokered deposits and the interest rates we offer on deposits, and various actions to improve our asset quality and reduce the risk inherent in the Bank's loan portfolio. In addition, we could be required to develop and implement various written plans to improve oversight functions, capital, credit risk management, strategic planning and budgeting, interest rate risk, and liquidity and funds management. As with our Memorandums of Understanding, we expect that our management and board of directors will be required to focus considerable time and attention on taking corrective actions to comply with the Consent Order's terms.

#### Note 12 – 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 July 2010, the FASB issued ASU 2010-20, Disclosure about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. In order to provide greater transparency, this ASU requires significant new disclosures on a disaggregated basis about the allowance for credit losses (i.e., allowance for loan losses for banks) and the credit quality of financing receivables (i.e., loans for banks). Under the ASU, a rollforward schedule of the allowance for loan losses, with the ending allowance balance further disaggregated on the basis of the impairment method, along with the related ending loan balance and significant purchases and sales of loans during the period are to be disclosed by portfolio segment. Additional disclosures are required by class of loan, including credit quality, aging of past due loans, nonaccrual status and impairment information. Disclosure of the nature and extent of troubled debt restructurings ("TDR") that occurred during the period and their effect on the allowance for loan losses as well as the effect on the allowance of TDRs that occurred within the prior twelve months and that defaulted during the current reporting period will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the loan portfolio's risk and performance. The majority of disclosures required as of the end of a reporting period were effective as of December 31, 2010. Upon adoption of those portions of the ASU on December 31, 2010, we began providing the required end of period disclosures as currently presented in Note 3. The disclosures about activity were effective January 1, 2011. Upon adoption of the final portion of the ASU in our 2011 first quarter, we began providing the required activity disclosures, with the exception of the new TDR related disclosures, as currently presented in Note 3. In January 2011, the FASB issued ASU 2011-01, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20, which temporarily deferred the effective date for disclosures related to TDRs. Beginning with the 2011 third quarter, we began providing the required TDR disclosures as presented in Note 3.

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income, Topic 220. This ASU eliminates the option of presenting the components of other comprehensive income (OCI) as part of the statement of changes in stockholders' equity. The ASU instead permits an entity to present the total of comprehensive income, the components of net income, and the components of OCI either in a single continuous statement of comprehensive income or in two separate but consecutive statements. With either format, the entity is required to present each component of net income along with total net income, each component of OCI along with the total for OCI, and a total amount for comprehensive income. Also, the ASU requires entities to present, for either format, reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. This ASU is to be applied retrospectively. For public entities, the ASU is effective for interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. Early adoption is permitted, since compliance with the amendments is already permitted.



## ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### 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" or 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 assumptions underlying the establishment of allowances for loan losses, and other estimates;
- the inability of the Bank to comply with the requirements of agreements with its regulators;
- the risks of changes in interest rates on levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities;
- changes in market conditions, specifically declines in the residential and commercial real estate market, volatility and disruption of the capital and credit markets, soundness of other financial institutions we do business with;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- changes in operations of Village Bank Mortgage Corporation as a result of the activity in the residential real estate market;
- legislative and regulatory changes, including the Financial Reform Act and other changes in banking, securities, and tax laws and regulations and their application by our regulators, and changes in scope and cost of FDIC insurance and other coverages;
- exposure to repurchase loans sold to investors for which borrowers failed to provide full and accurate information on or related to their loan application or for which appraisals have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor;
- the effects of future economic, business and market conditions;
- governmental monetary and fiscal policies;
- changes in accounting policies, rules and practices;
- maintaining capital levels adequate to remain well capitalized;
- reliance on our management team, including our ability to attract and retain key personnel;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- demand, development and acceptance of new products and services;
- problems with technology utilized by us;
- changing trends in customer profiles and behavior; and
- other factors described from time to time in our reports filed with the SEC

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. In addition we provide investment services through a separate division of the Bank, Village Investment Services. 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.

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 collectability of the loan portfolio based on its experience and evaluation of economic conditions as well as the current financial condition of its borrowers and their ability to repay loans. 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. During the third quarter of 2011, based on our continuing efforts to evaluate such assumptions and judgments, we determined that continuing depressed market conditions as well as some financial difficulties experienced by some of our more significant borrowers warranted the addition of a significant provision for loan losses of \$9.5 million, resulting in a provision for loan losses of \$11.4 million for the nine months ended September 30, 2011. Although we believe that the allowance for loan losses of \$14,962,000 at September 30, 2011, which represents 3.43% of loans outstanding, is adequate to absorb potential losses in the Company's loan portfolio at that date, we can make no assurance that significant provisions for loan losses will not be necessary in the future. The continuation of depressed economic conditions, especially in our primary market area, will have a negative effect on the collectability of our loan portfolio.

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.

For the three months ended September 30, 2011, the Company had a net loss totaling \$(5,245,000) and a net loss available to common shareholders of \$(5,467,000), or \$(1.29) per fully diluted share, compared to net income of \$334,000 and net income available to common shareholders of \$112,000, or \$0.03 per fully diluted share, for the same period in 2010. The most significant factor in our decline in earnings was the provision for loan losses of \$9,508,000 in the third quarter of 2011 compared to a provision for loan losses of \$1,410,000 for the same period in 2010.

Our total assets increased to \$605,841,000 at September 30, 2011 from \$591,779,000 at December 31, 2010, an increase of \$14,062,000, or 2.4%. Liquid assets (cash and due from banks, federal funds sold, and investment securities available for sale) increased by \$44,833,000, loans held for sale decreased by \$(6,086,000), and net portfolio loans decreased by \$(24,724,000). The net increase in assets of \$20,882,000 was funded primarily by increases in deposits of \$5,159,000 and borrowings of \$9,942,000.

As a result of an examination performed by the FDIC in the first quarter of 2011, the Bank expects to enter into a Consent Order with the FDIC in the fourth quarter of 2011. We are currently in discussions with the FDIC concerning the content of the Consent Order and do not know its exact requirements at this time. We believe, however, that those requirements, once finalized, will be more restrictive than those currently contained in the Bank's Memorandum of Understanding with the FDIC. In particular, we expect that, among other things, the Consent Order could require an evaluation of management, new capital requirements, restrictions on asset growth, limitations on our ability to use brokered deposits and the interest rates we offer on deposits, and various actions to improve our asset quality and reduce the risk inherent in the Bank's loan portfolio. In addition, we could be required to develop and implement various written plans to improve oversight functions, capital, credit risk management, strategic planning and budgeting, interest rate risk, and liquidity and funds management. As with our Memorandums of Understanding, we expect that our management and board of directors will be required to focus considerable time and attention on taking corrective actions to comply with the Consent Order's terms.

The following presents management's discussion and analysis of the financial condition of the Company at September 30, 2011 and December 31, 2010, and results of operations for the Company for the three and nine month periods ended September 30, 2011 and 2010. This discussion should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2010 as filed with the Securities and Exchange Commission as well as the third quarter 2011 financial statements and notes thereto appearing elsewhere in this report.

#### Results of operations

For the three months ended September 30, 2011, the Company had a net loss of \$(5,245,000) and a net loss available to common shareholders of \$(5,467,000), or \$(1.29) per fully diluted share, compared to net income of \$334,000 and net income available to common shareholders of \$112,000, or \$0.03 per fully diluted share, for the same period in 2010. For the nine months ended September 30, 2011, the Company had a net loss of \$(4,905,000) and a net loss available to common shareholders of \$(5,566,000), or \$(1.31) per fully diluted share, compared to net income totaling \$1,282,000 and net income available to common shareholders of \$622,000, or \$0.15 per share on a fully diluted share, for the same period in 2010.



The components of these decreases in net income before payment of dividends are presented following:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Increase (decrease) in net interest income	\$ (77,000 )	\$ 780,000
Increase in provision for loan losses	(8,098,000)	(8,261,000)
Decrease in noninterest income	(65,000 )	(799,000 )
Increase in noninterest expense	(183,000 )	(997,000 )
Decrease in tax expense	2,844,000	3,090,000
	\$ (5,579,000)	\$ (6,187,000)

Our profitability continues to be negatively affected by the continued stress on our borrowers and real estate values from the recessionary economy. To obtain an accurate picture of our earnings, it is important to understand what our “core earnings” is, defined as pretax earnings adjusted for gains and losses on sales of assets other than loan sales by the mortgage company as well as the effect of problem assets. Core earnings is not a measurement under accounting principles generally accepted in the United States. The following table presents our core earnings as defined for the indicated periods:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Pretax income (loss) per generally accepted accounting principles	\$(7,916,280)	\$506,229	\$(7,335,023)	\$1,942,016
Less gain (loss) on sale of Securities	108,473	-	171,617	597,375
Assets	-	-	-	242,936
	108,473	-	171,617	840,311
Add				
Provision for loan losses	9,507,884	1,410,000	11,410,884	3,150,000
Other real estate owned expenses	387,666	327,261	1,211,878	1,008,597
	9,895,550	1,737,261	12,622,762	4,158,597
Pretax core earnings	1,870,797	2,243,490	5,116,122	5,260,302
Income tax expense	636,071	762,787	1,739,481	1,788,503
Net core earnings	\$1,234,726	\$1,480,703	\$3,376,641	\$3,471,799

## 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 third quarter of \$4,964,000 represents a decrease of \$(77,000), or 2%, compared to the third quarter of 2010, and an increase of \$26,000, or 1%, compared to the second quarter of 2011. While these changes in net interest income are not material, changes in the components of net interest income are worthy of note. Yields on assets have declined from 5.69% for the third quarter of 2010, to 5.28% for the second quarter of 2011 and 5.09% for the third quarter of 2011. This decline in yields on interest earning assets is a result of a strategic shift by management in the makeup of our interest-earning assets, from loans to investment securities and federal funds sold, primarily to increase liquidity. Yields on loans are generally higher than yields on more liquid assets such as investment securities and federal funds sold. Additionally, an increase in nonaccrual loans has had a negative effect on asset yields.

Our cost of funds has also declined from 2.06% for the third quarter of 2010, to 1.73% for the second quarter of 2011 and 1.59% for the third quarter of 2011. The decline in our cost of funds is a result of the repricing of higher cost certificates of deposit during the low interest rate environment that has existed for the last two years as well as an effort to change our deposit mix so that we are not so dependent on higher cost deposits. Additionally, we have been able to reprice borrowings at lower rates as they matured.

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. Our net interest margin over the last several quarters is provided in the following table:

Quarter Ended	Net Interest Margin
September 30, 2010	3.74 %
December 31, 2010	3.84 %
March 31, 2011	3.79 %
June 30, 2011	3.65 %
September 30, 2011	3.63 %

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. As our deposits repriced downward and the yield on interest earning assets stabilized, our net interest margin reflected an upward trend through the end of 2010. The small decline in the net interest margin in the first nine months of 2011 is a result of the strategic shift in our interest-earning assets from loans to investment securities and federal funds sold and the increase in nonaccrual loans discussed previously. Given the difficult economy and the potential impact on interest income from new nonaccrual loans, no assurance can be provided that the net interest margin will not continue to decline.



Average interest-earning assets for the first nine months of 2011 decreased by \$1,374,000, or 0.3% compared to the first nine months of 2010. The decrease in interest-earning assets was due primarily to decreases in loans of \$21,874,000 and loans held for sale of \$3,982,000 offset by increases in investment securities of \$14,812,000 and federal funds sold of \$9,670,000. The average yield on interest-earning assets decreased to 5.29% for the first nine months of 2011 compared to 5.57% for the same period in 2010. 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. 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 decreased by \$10,130,000, or 2.0%, for the first nine months of 2011 compared to the first nine months of 2010. The decrease in interest-bearing liabilities was due to declines in average deposits of \$8,263,000 and other borrowings of \$1,867,000. The average cost of interest-bearing liabilities decreased to 1.73% for the first nine months of 2011 from 2.21% for the first nine months of 2010. The principal reason for the decrease in liability costs was the continuation of historic low short-term interest rates by the Federal Reserve. See our discussion of interest rate sensitivity below for more information.

The following tables illustrate 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 Sheets  
(in thousands)

	Three Months Ended September 30, 2011				Three Months Ended September 30, 2010			
	Average Balance	Interest Income/ Expense	Annualized Yield Rate		Average Balance	Interest Income/ Expense	Annualized Yield Rate	
Loans	\$441,461	\$6,469	5.81	%	\$461,442	\$7,190	6.18	%
Investment securities	54,875	357	2.58	%	29,844	237	3.15	%
Loans held for sale	10,268	117	4.52	%	18,752	219	4.63	%
Federal funds and other	35,625	20	0.22	%	24,297	14	0.23	%
Total interest earning assets	542,229	6,963	5.09	%	534,335	7,660	5.69	%
Allowance for loan losses and deferred fees	(7,423 )				(9,384 )			
Cash and due from banks	13,589				14,751			
Premises and equipment, net	27,245				27,665			
Other assets	31,303				34,235			
Total assets	\$606,943				\$601,602			
Interest bearing deposits								
Interest checking	\$38,226	\$52	0.54	%	\$32,705	\$58	0.70	%
Money market	85,361	116	0.54	%	97,384	236	0.96	%
Savings	13,199	22	0.66	%	10,323	18	0.69	%
Certificates	309,277	1,504	1.93	%	312,706	1,857	2.36	%
Total deposits	446,063	1,694	1.51	%	453,118	2,169	1.90	%
Borrowings	53,622	305	2.26	%	51,412	450	3.47	%
Total interest bearing liabilities	499,685	1,999	1.59	%	504,530	2,619	2.06	%
Noninterest bearing deposits	53,139				44,189			
Other liabilities	4,210				2,910			
Total liabilities	557,034				551,629			
Equity capital	49,910				49,973			
Total liabilities and capital	\$606,944				\$601,602			
Net interest income before provision for loan losses		\$4,964				\$5,041		
Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities			3.51	%			3.63	%
Annualized net interest margin (net interest income expressed as			3.63	%			3.74	%

percentage of average earning  
assets)

29

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Average Balance Sheets  
(in thousands)

	Nine Months Ended September 30, 2011			Nine Months Ended September 30, 2010		
	Average Balance	Interest Income/Expense	Annualized Yield Rate	Average Balance	Interest Income/Expense	Annualized Yield Rate
Loans	\$ 443,212	\$ 20,037	6.04 %	\$ 465,087	\$ 21,225	6.10 %
Investment securities	53,911	1,010	2.50 %	39,099	880	3.01 %
Loans held for sale	9,509	358	5.03 %	13,491	488	4.84 %
Federal funds and other	35,552	58	0.22 %	25,881	44	0.23 %
Total interest earning assets	542,184	21,463	5.29 %	543,558	22,637	5.57 %
Allowance for loan losses and deferred fees	(7,480 )			(9,665 )		
Cash and due from banks	9,102			12,565		
Premises and equipment, net	27,361			27,718		
Other assets	32,256			33,953		
Total assets	\$ 603,423			\$ 608,129		
Interest bearing deposits						
Interest checking	\$ 36,479	\$ 184	0.67 %	\$ 35,512	\$ 274	1.03 %
Money market	89,342	487	0.73 %	104,034	863	1.11 %
Savings	12,176	63	0.69 %	10,018	62	0.83 %
Certificates	315,547	4,905	2.08 %	312,244	5,760	2.47 %
Total deposits	453,544	5,639	1.66 %	461,808	6,959	2.01 %
Borrowings	50,381	885	2.35 %	52,247	1,520	3.89 %
Total interest bearing liabilities	503,925	6,524	1.73 %	514,055	8,479	2.21 %
Noninterest bearing deposits	47,884			41,332		
Other liabilities	3,334			2,760		
Total liabilities	555,143			558,147		
Equity capital	48,280			49,982		
Total liabilities and capital	\$ 603,423			\$ 608,129		
Net interest income before		\$ 14,939			\$ 14,158	

provision for loan  
losses

Interest spread - average yield on  
interest  
earning assets, less  
average rate on  
interest bearing  
liabilities

3.56 %

3.36 %

Annualized net  
interest margin  
(net  
interest income  
expressed as  
percentage of  
average earning  
assets)

3.68 %

3.48 %

## Asset quality and provision for loan losses

The provision for loan losses for the three months ended September 30, 2011 amounted to \$9,508,000 compared to \$1,410,000 for the three months ended September 30, 2010. The provision for loan losses for the nine months ended September 30, 2011 was \$11,411,000 compared to \$3,150,000 for the nine months ended September 30, 2010. The significant increase in the provision for loan losses in 2011 reflects management's determination that continuing depressed market conditions in 2011 as well as some financial difficulties experienced by some of our more significant borrowers warranted the addition of a significant provision for loan losses in the third quarter. Although we believe that the allowance for loan losses of \$14,962,000 at September 30, 2011, which represents 3.43% of loans outstanding, is adequate to absorb potential losses in the Company's loan portfolio at that date, we can make no assurance that significant provisions for loan losses will not be necessary in the future. The continuation of depressed economic conditions, especially in our primary market area, will have a negative effect on the collectability of our loan portfolio.

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

	Sept 30, 2011	June 30, 2011	March 31, 2011	Dec 31, 2010	Sept 30, 2010
Nonaccrual loans					
Number	130	102	97	106	117
Amount	\$26,643	\$17,902	\$17,568	\$20,324	\$23,943
Other real estate owned	8,937	11,982	13,505	12,028	12,941
Nonperforming assets	\$35,580	\$29,884	\$31,073	\$32,352	\$36,884
Percentage of total assets	5.87	% 4.88	% 5.11	% 5.47	% 6.32

The significant increase in nonperforming assets in the third quarter of 2011 reflects the continued stress of the depressed economy on our borrowers. Our approach to troubled lending relationships is to work with the borrower to the extent possible and still adhere to strong credit management guidelines. However, once we determine that it is doubtful that a borrower will have the financial ability to repay all principal and interest due on the loan, we will place the loan on nonaccrual status. If the economy continues to be depressed at the levels we have experienced from the latter part of 2008 through 2010, nonperforming assets could increase. 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 September 30, 2011, there were three loans past due 90 days or more and still accruing interest totaling \$102,000, compared to six loans totaling \$315,000 at December 31, 2010. 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.

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

As of and for the three months ended

	Sept 30, 2011	June 30, 2011	Mar 31, 2011	Dec 31, 2010	Sept 30, 2010
Loans 90 days past due and still accruing	\$ 102	\$ 843	\$ 440	\$ 315	\$ 738
Restructured loans	32,008	25,130	25,932	21,695	21,703
Nonaccrual loans	26,643	17,901	17,568	20,324	23,943
Other real estate owned	8,937	11,982	13,505	12,028	12,941
Allowance for loan losses					
Beginning balance	\$ 7,256	\$ 7,434	\$ 7,312	\$ 9,819	\$ 9,500
Provision for loan losses	9,508	900	1,003	1,692	1,410
Charge-offs	(1,812 )	(1,089 )	(883 )	(4,207 )	(1,091 )
Recoveries	10	11	2	8	-
Ending balance	\$ 14,962	\$ 7,256	\$ 7,434	\$ 7,312	\$ 9,819
Ratios					
Allowance for loan losses to Loans, net of unearned income	3.43 %	1.64 %	1.68 %	1.61 %	2.14 %
Nonaccrual loans	56.16 %	40.53 %	42.32 %	35.98 %	41.01 %
Nonperforming assets to total assets	5.87 %	4.88 %	5.11 %	5.47 %	6.32 %

Noninterest income

Noninterest income decreased from \$2,662,000 for the three months ended September 30, 2010 to \$2,597,000 for the three months ended September 30, 2011, a decrease of \$65,000, or 2%. Noninterest income also decreased from \$7,859,000 for the first nine months of 2010 to \$7,060,000 for the first nine months of 2011, a decrease of \$799,000, or 10%. The decrease in noninterest income for the nine month period comparison is primarily a result of lower gain on sale of assets in 2011.

Noninterest expense

Noninterest expense for the three months ended September 30, 2011 was \$5,970,000 compared to \$5,787,000 for the three months ended September 30, 2010, an increase of \$183,000, or 3%. The more significant increases in noninterest expense occurred in professional and outside services of \$140,000 and expenses related to foreclosed real estate of \$60,000.

Noninterest expense for the nine months ended September 30, 2011 totaled \$17,922,000, an increase of \$996,000, or 6%, from \$16,926,000 for the nine months ended September 30, 2010. Salaries and benefits increased by \$371,000,

or 4%, professional and outside services increased by \$212,000, or 14%, and expenses related to foreclosed real estate increased by \$203,000, or 20%. The increase in salaries and benefits is primarily attributable to promotional raises.

## Income taxes

The income tax benefit of \$2,430,000 for the nine months ended September 30, 2011 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 September 30, 2011. 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 \$258,000 and \$274,000 for the nine months ended September 30, 2011 and 2010, respectively.

## Loan portfolio

A management objective is to maintain the quality of the loan portfolio. The Company seeks to achieve this objective by maintaining rigorous underwriting standards coupled with regular evaluation of the creditworthiness of and the designation of lending limits for each borrower. The portfolio strategies include seeking industry and loan size diversification in order to minimize credit exposure and originating loans in markets with which the Company is familiar.

The Company's real estate loan portfolios, which represent approximately 90% of all loans, are secured by mortgages on real property located principally in the Commonwealth of Virginia. Sources of repayment are from the borrower's operating profits, cash flows and liquidation of pledged collateral. The Company's commercial loan portfolio represents approximately 9% of all loans. Loans in this category are typically made to individuals, small and medium-sized businesses and range between \$250,000 and \$2.5 million. Based on underwriting standards, commercial and industrial loans may be secured in whole or in part by collateral such as liquid assets, accounts receivable, equipment, inventory, and real property. The collateral securing any loan may depend on the type of loan and may vary in value based on market conditions. The remainder of our loan portfolio is in consumer loans which represent 1% of the total.



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

	September 30, 2011		December 31, 2010		
	Amount	%	Amount	%	
Commercial	\$37,962	8.7	% \$37,228	8.2	%
Real estate - Construction, land development & other loans	86,467	19.8	% 90,773	20.0	%
Real estate - Commercial	166,808	38.3	% 173,227	38.2	%
Real estate - 1-4 Residential	140,035	32.1	% 146,647	32.4	%
Consumer	4,792	1.1	% 5,368	1.2	%
Total loans	436,064	100.0	% 453,243	100.0	%
Deferred loan cost (unearned income), net	729		624		
Less: Allowance for loan losses	(14,962 )		(7,312 )		
	\$421,831		\$446,555		

The Company assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

- Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. 1-4 assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
- Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;
- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any, and;
- Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	Total Loans
Commercial	\$33,335,341	\$1,581,393	\$2,600,679	\$444,439	\$37,961,852
Real estate - Construction, land development and other loans	53,953,677	4,743,187	27,770,580	-	86,467,444
Real estate - Commercial	98,128,635	21,906,607	46,459,498	313,244	166,807,984
Real estate - 1-4 Residential	120,080,357	9,293,980	10,602,621	58,008	140,034,966
Consumer	3,509,806	678,697	464,006	139,208	4,791,717
	\$309,007,816	\$38,203,864	\$87,897,384	\$954,899	\$436,063,963

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The following table presents the aging of the recorded investment in past due loans and leases as of September 30, 2011:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial Real estate - Construction, land development and other loans	\$52,401	\$72,666	\$11,558	\$136,625	\$37,825,227	\$37,961,852	\$11,558
Real estate - Commercial	569,219	991,594	-	1,560,813	84,906,631	86,467,444	-
Real estate - 1-4 Residential	694,707	2,645,910	71,620	3,412,237	163,395,747	166,807,984	71,620
Consumer	1,012,321	2,254,390	18,700	3,285,411	136,749,555	140,034,966	18,700
	136,830	2,992	-	139,822	4,651,895	4,791,717	-
	\$2,465,478	\$5,967,552	\$101,878	\$8,534,908	\$427,529,055	\$436,063,963	\$101,878

Loans are considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Impaired loans at September 30, 2011 are set forth in the following table.

Description of Loans	Recorded Investment					
	Unpaid Contractual Principal Balance	Total Recorded Investment	Recorded Investment with Allowance	Recorded Investment With No Allowance	Related Allowance	Recorded Average Investment
Commercial Real estate - Construction, land development & other loans	\$282,900	\$282,900	\$-	\$282,900	\$-	\$1,568,978
Real estate - Commercial	17,805,728	17,805,728	12,198,793	5,606,935	4,807,768	7,640,348
Real estate - 1-4 Residential	15,663,417	15,663,417	13,748,400	1,915,017	2,290,960	5,226,868
Consumer	13,607,020	13,607,020	5,274,198	8,332,822	1,779,100	8,088,665
	493,341	493,341	-	493,341	-	292,430

\$47,852,406 \$47,852,406 \$31,221,391 \$16,631,015 \$8,877,828 \$22,817,289

#### Allowance for loan losses

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. An allowance for loan losses is established through a provision for loan losses based upon 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.

The level of the allowance for loan losses is determined by an ongoing detailed analysis of risk and loss potential within the portfolio as a whole. Outside of our own analysis, our reserve adequacy and methodology are reviewed on a regular basis by an independent firm and bank regulators.

The overall allowance for loan losses is equivalent to 3.43% of total loans net of deferred fees. The schedule below, Analysis of Allowance for Loan Losses, reflects the pro rata allocation by the different loan types. The methodology as to how the allowance was derived is a combination of specific allocations and percentage allocations of the unallocated portion of the allowance for loan losses, as discussed below. The Company has developed a comprehensive risk weighting system based on individual loan characteristics that enables the Company to allocate the composition of the allowance for loan losses by types of loans.

The methodology as to how the allowance was derived is detailed below. Unallocated amounts included in the allowance for loan losses have been applied to the loan classifications on a percentage basis.

Adequacy of the reserve is assessed, and appropriate expense and charge-offs are taken, no less frequently than at the close of each fiscal quarter end. The methodology by which we systematically determine the amount of our reserve is set forth by the board of directors in our Loan Policy. Under this Policy, management is charged with ensuring that each loan is individually evaluated and the portfolio characteristics are evaluated to arrive at an appropriate aggregate reserve. The results of the analysis are documented, reviewed and approved by the board of directors no less than quarterly. The following elements are considered in this analysis: individual loan risk ratings, lending staff changes, loan review and board oversight, loan policies and procedures, portfolio trends with respect to volume, delinquency, composition/concentrations of credit, risk rating migration, levels of classified credit, off-balance sheet credit exposure, any other factors considered relevant from time to time (the “general reserve”); loss estimates on specific problem credits (the “specific reserve”), and, finally, an “unallocated reserve” to cover any unforeseen factors as a result of current economic conditions. Each of the reserve components, general, specific and unallocated are discussed in further detail below.

With respect to the general reserve, all loans are graded or “Risk Rated” individually for loss potential at the time of origination and as warranted thereafter, but no less frequently than quarterly. Loss potential factors are applied based upon a blend of the following criteria: our own direct experience; our collective management experience in administering similar loan portfolios in the market; and peer data contained in statistical releases issued by the FDIC. Management’s collective experience at this company and other banks is the most heavily weighted criterion, and the weighting is subjective and varies by loan type, amount, collateral, structure, and repayment terms. Prevailing economic conditions generally and within each individual borrower’s business sector are considered, as well as any changes in the borrower’s own financial position and, in the case of commercial loans, management structure and business operations.

When deterioration develops in an individual credit, the loan is placed on a “Watch List” and the loan is monitored more closely. All loans on the watch list are evaluated for specific loss potential based upon either an evaluation of the liquidated value of the collateral or cash flow deficiencies. If management believes that, with respect to a specific loan, an impaired source of repayment, collateral impairment or a change in a debtor’s financial condition presents a heightened risk of non-performance of a particular loan, a portion of the reserve may be specifically allocated to that individual loan. The aggregation of this loan by loan loss analysis comprises the specific reserve.

The unallocated reserve is maintained to absorb risk factors outside of the general and specific reserves. To arrive at the unallocated reserve, the loan portfolio is “shocked” or downgraded by a certain percentage based on management’s subjective assessment of the state of the economy. The current depressed economy resulted in an increase in the percentage downgrade of the loan portfolio.

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The allowance for loan losses at September 30, 2011 was \$14,962,000, compared to \$7,312,000 at December 31, 2010. The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) at September 30, 2011 and December 31, 2010 was 3.43% and 1.61%, respectively. 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 (dollars in thousands).

	Nine Months September 30,	
	2011	2010
Beginning balance	\$ 7,312	\$ 10,522
Provision for loan losses	11,411	3,150
Charge-offs		
Commercial	(193 )	(804 )
Real estate - Construction, land development & other loans	(327 )	(957 )
Real estate - Commercial	(1,635 )	(1,228 )
Real estate - 1-4 Residential	(1,443 )	(1,017 )
Consumer	(187 )	(153 )
	(3,785 )	(4,159 )
Recoveries		
Commercial	19	203
Real estate - Construction, land development & other loans	-	1
Real estate - Commercial	2	-
Real estate - 1-4 Residential	1	101
Consumer	2	1
	24	306
Net charge-offs	(3,761 )	(3,853 )
Ending balance	\$ 14,962	\$ 9,819
Loans outstanding at end of period(1)	\$ 436,793	\$ 458,126
Ratio of allowance for loan losses as a percent of loans outstanding at end of period	3.43 %	2.14 %
Average loans outstanding for the period(1)	\$ 443,212	\$ 465,087
Ratio of net charge-offs to average loans outstanding for the period	0.85 %	0.83 %

(1) Loans are net of unearned income.

The increase in the ratio of the allowance for loan losses as a percent of loans outstanding is attributable to management's determination that a significant provision for loan losses of \$9,508,000 was warranted in the third quarter of 2011 due to a continued depressed economy as well as some financial difficulties experienced by some of our more significant borrowers.

## Deposits

Total deposits increased by \$5,159,000, or 1%, from \$499,012,000 at December 31, 2010 to \$504,171,000 at September 30, 2011, as compared to a decrease of \$(8,232,000), or 2%, during the first nine months of 2010. Checking and savings accounts increased by \$30,918,000, money market accounts decreased by \$(6,413,000) and time deposits decreased by \$(19,346,000). The cost of our interest bearing deposits declined to 1.66% for the first nine months of 2011 compared to 2.01% for the first nine months of 2010.

While the mix of our deposits continues to be weighted toward time deposits, such deposits represent only 60% of total deposits at September 30, 2011 and 65% at December 31, 2010. 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 as well as any restrictions on deposit interest rates that may be included in the Consent Order with the FDIC.

## 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 \$37,750,000 and \$28,750,000 at September 30, 2011 and December 31, 2010 respectively. The FHLB advances are secured by the pledge of first mortgage loans, investment securities and our FHLB stock. Available borrowings at September 30, 2011 were approximately \$9.0 million.

## Capital resources

Stockholders' equity at September 30, 2011 was \$43,997,000, compared to \$48,320,000 at December 31, 2010. 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 \$(4,323,000) decrease in equity during the first nine months of 2011 was primarily due to the net loss of \$(4,905,000).

Pursuant to the Memorandums of Understanding, the Company has agreed not to declare or pay any dividends on common stock or preferred stock, including the TARP preferred, or make any payments on its trust preferred securities, without prior regulatory approval.

In May 2011, the Company notified the U.S. Treasury that the Company was going to defer the payment of the quarterly cash dividend of \$184,225 due on May 16, 2011, and subsequent quarterly payments, on the Fixed Rate Cumulative Perpetual Preferred Stock, Series A. The total arrearage on such preferred stock as of the date of this filing is \$464,458.

During the first quarter of 2005, the Company issued \$5.2 million in Trust Preferred Capital Notes to increase its regulatory capital and to help fund its expected growth in 2005. During the third quarter of 2007, the Company issued \$3.6 million in Trust Preferred Capital Notes to partially fund the construction of an 80,000 square foot building completed in 2008. 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 Company elected to defer interest payments on the Trust Preferred Capital Notes of \$89,135 due on June 15, 2011, and \$89,135 due on September 15, 2011. We also anticipate deferring interest payments of approximately \$89,000 due December 15, 2011. Although we elected to defer payment of the interest due, the amount has been accrued and is included in interest expense.

The following table presents the composition of the Company's regulatory capital and the capital ratios at the dates indicated (dollars in thousands).



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	September 30, 2011	December 31, 2010		
Tier 1 capital				
Preferred stock	\$ 59	\$ 59		
Common stock	16,973	16,954		
Additional paid-in capital	40,703	40,634		
Retained earnings (deficit)	(14,758 )	(9,193 )		
Warrant Surplus	732	732		
Discount on preferred stock	(383 )	(492 )		
Qualifying trust preferred securities	8,764	8,764		
Total Tier 1 capital	52,090	57,458		
 Tier 2 capital				
Allowance for loan losses	5,677	5,900		
Total Tier 2 capital	57,767	63,358		
 Total risk-based capital	 \$ 57,767	 \$ 63,358		
 Risk-weighted assets	 \$ 444,868	 \$ 470,662		
 Average assets	 \$ 596,061	 \$ 596,765		
 Capital ratios				
Leverage ratio (Tier 1 capital to average assets)	8.74	%	9.63	%
Tier 1 capital to risk-weighted assets	11.71	%	12.21	%
Total capital to risk-weighted assets	12.99	%	13.46	%
Equity to total assets	7.26	%	8.17	%

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The Bank meets the criteria to be categorized as a “well capitalized” institution as of September 30, 2011 and December 31, 2010. In addition, in December 2010 the Bank entered into a memorandum of understanding with the FDIC that it must maintain a leverage ratio of more than 8% and a total capital to risk-weighted assets ratio of more than 11.5%. The Bank did not meet this requirement as of September 30, 2011 as its leverage ratio was 7.74%. When capital falls below the “well capitalized” requirement, consequences can include: new branch approval could be withheld; more frequent examinations by the FDIC; brokered deposits cannot be renewed without a waiver from the FDIC; and other potential limitations as described in FDIC Rules and Regulations sections 337.6 and 303, and FDIC Act section 29. In addition, the FDIC insurance assessment increases when an institution falls below the “well capitalized” classification.

#### 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.

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At September 30, 2011, cash, cash equivalents and investment securities available for sale totaled \$110,443,000, or 18.2% of total assets, which we believe is adequate to meet short-term liquidity needs.

At September 30, 2011, we had commitments to originate \$48,768,000 of loans as compared to \$59,240,000 at December 31, 2010. The decrease 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 September 30, 2011. Time deposits scheduled to mature in the 12-month period ending September 30, 2012 totaled \$119,420,000 at September 30, 2011. 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 September 30, 2011. 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.

## Interest Rate Sensitivity GAP Analysis

September 30, 2011

(In thousands)

	Within 3 Months	3 to 6 Months	6 to 12 Months	13 to 36 Months	More than 36 Months	Total				
<b>Interest Rate Sensitive Assets</b>										
<b>Loans (1)</b>										
Fixed rate	\$30,033	\$16,659	\$24,890	\$39,925	\$111,476	\$222,983				
Variable rate	94,067	7,324	9,261	27,268	75,161	213,081				
Investment securities	56	-	-	16	56,619	56,691				
Loans held for sale	13,786	-	-	-	-	13,786				
Federal funds sold	5,787	-	-	-	-	5,787				
<b>Total rate sensitive assets</b>	<b>143,729</b>	<b>23,983</b>	<b>34,151</b>	<b>67,209</b>	<b>243,256</b>	<b>512,328</b>				
<b>Cumulative rate sensitive assets</b>	<b>143,729</b>	<b>167,712</b>	<b>201,863</b>	<b>269,072</b>	<b>512,328</b>					
<b>Interest Rate Sensitive Liabilities</b>										
Interest checking (2)	-	-	-	39,356	-	39,356				
Money market accounts	83,743	-	-	-	-	83,743				
Savings (2)	-	-	-	13,562	-	13,562				
Certificates of deposit	30,577	36,964	51,879	113,931	71,293	304,644				
FHLB advances	-	1,000	8,750	18,000	10,000	37,750				
Trust Preferred Securities	-	-	-	-	8,764	8,764				
Federal funds purchased	-	-	-	-	-	-				
Other borrowings	5,107	-	-	-	-	5,107				
<b>Total rate sensitive liabilities</b>	<b>119,427</b>	<b>37,964</b>	<b>60,629</b>	<b>184,849</b>	<b>90,057</b>	<b>492,926</b>				
<b>Cumulative rate sensitive liabilities</b>	<b>119,427</b>	<b>157,391</b>	<b>218,020</b>	<b>402,869</b>	<b>492,926</b>					
<b>Rate sensitivity gap for period</b>	<b>\$24,302</b>	<b>\$(13,981 )</b>	<b>\$(26,478 )</b>	<b>\$(117,640 )</b>	<b>\$153,199</b>	<b>\$19,402</b>				
<b>Cumulative rate sensitivity gap</b>	<b>\$24,302</b>	<b>\$10,321</b>	<b>\$(16,157 )</b>	<b>\$(133,797 )</b>	<b>\$19,402</b>					
<b>Ratio of cumulative gap to total assets</b>	<b>4.0</b>	<b>%</b>	<b>1.7</b>	<b>%</b>	<b>(2.7 )%</b>	<b>(22.1 )%</b>	<b>3.2</b>	<b>%</b>		
<b>Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities</b>	<b>120.3</b>	<b>%</b>	<b>106.6</b>	<b>%</b>	<b>92.6</b>	<b>%</b>	<b>66.8</b>	<b>%</b>	<b>103.9</b>	<b>%</b>
<b>Ratio of cumulative gap to cumulative rate sensitive assets</b>	<b>16.9</b>	<b>%</b>	<b>6.2</b>	<b>%</b>	<b>(8.0 )%</b>	<b>(49.7 )%</b>	<b>3.8</b>	<b>%</b>		

- (1) Includes nonaccrual loans of approximately \$24,558,000, 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 September 30, 2011, our balance sheet is asset sensitive for the first three months, meaning that our assets reprice more quickly than our liabilities during that period, and liability sensitive for the next thirty-three months, meaning that our liabilities will reprice more quickly than our assets during that period, with a ratio of cumulative gap to total assets ranging from a positive gap of 4.0% for the first three months to a negative gap of (22.1)% for thirteen to thirty six month period. A negative gap can adversely affect earnings in periods of increasing interest rates. Given expectations of rising interest rates by the end of 2011, we believe our balance sheet should be asset sensitive and, accordingly, 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 of the Company and its subsidiary are in accordance with accounting principles generally accepted in the United States of America ("GAAP") and conform to general practices within the banking industry. The Company's financial position and results of operations are affected by management's application of accounting policies, including estimates, assumptions and judgments made to arrive at the carrying value of assets and liabilities, and amounts reported for revenues, expenses and related disclosures. Different assumptions in the application of these policies could result in material changes in the Company's consolidated financial position and/or results of operations.

The more critical accounting and reporting policies include the Company's accounting for the allowance for loan losses, real estate acquired in settlement of loans, goodwill and income taxes. The Company's accounting policies are fundamental to understanding the Company's consolidated financial position and consolidated results of operations. Accordingly, the Company's significant accounting policies are discussed in detail in Note 1 of the Notes to Consolidated Financial Statements.

The following is a summary of the Company's critical accounting policies that are highly dependent on estimates, assumptions, and judgments.

#### 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.

### Troubled debt restructurings

A loan is accounted for as a troubled debt restructuring if we, for economic or legal reasons, grant a concession to a borrower considered to be experiencing financial difficulties that we would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or balance of the loan, a reduction of accrued interest, an extension of the maturity date or renewal of the loan at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans. Accruing troubled debt restructurings are generally excluded from nonperforming loans as it is considered probable that all contractual principal and interest due under the restructured terms will be collected.

In accordance with current accounting guidance, loans modified as troubled debt restructurings are, by definition, considered to be impaired loans. Impairment for these loans is measured on a loan-by-loan basis similar to other impaired loans as described above under Allowance for loan losses. Certain loans modified as troubled debt restructurings may have been previously measured for impairment under a general allowance methodology (i.e., pooling), thus at the time the loan is modified as a troubled debt restructuring the allowance will be impacted by the difference between the results of these two measurement methodologies. Loans modified as troubled debt restructurings that subsequently default are factored into the determination of the allowance in the same manner as other defaulted loans.

### Real estate acquired in settlement of loans

Real estate acquired in settlement of loans represent properties acquired through foreclosure or physical possession. Write-downs to fair value less cost to sell of foreclosed assets at the time of transfer are charged to allowance for loan losses. Subsequent to foreclosure, the Company periodically evaluates the value of foreclosed assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. Subsequent declines in value are charged to operations. Fair value is based on an assessment of information available at the end of a reporting period and depends upon a number of factors, including historical experience, economic conditions, and issues specific to individual properties. The evaluation of these factors involves subjective estimates and judgments that may change.

### Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established. Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if management projects lower levels of future taxable income. If such a valuation allowance is deemed necessary in the future, it would be established through a charge to income tax expense that would adversely affect operating results.





#### New accounting standards

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 July 2010, The FASB issued ASU No. 2010-20, Receivables - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, Topic 830. This ASU requires entities to provide disclosures designed to facilitate financial statement users' evaluation of(i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 will be effective for the Company's consolidated financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period will be required for the Company's consolidated financial statements that include periods beginning on or after January 1, 2011. This ASU requires additional disclosures only and will not have an impact on the Company's consolidated financial statements.

In June 2011, The FASB issued ASU No. 2011-05, Presentation of Comprehensive Income, Topic 220. This ASU eliminates the option of presenting the components of other comprehensive income (OCI) as part of the statement of changes in stockholders' equity. The ASU instead permits an entity to present the total of comprehensive income, the components of net income, and the components of OCI either in a single continuous statement of comprehensive income or in two separate but consecutive statements. With either format, the entity is required to present each component of net income along with total net income, each component of OCI along with the total for OCI, and a total amount for comprehensive income. Also, the ASU requires entities to present, for either format, reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. This ASU is to be applied retrospectively. For public entities, the ASU is effective for interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. Early adoption is permitted, since compliance with the amendments is already permitted.

#### Impact of inflation and changing prices

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 4 – CONTROLS AND PROCEDURES

Based upon an evaluation as of September 30, 2011 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 1A – RISK FACTORS

Other than as set forth below, there were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2010.

The Bank expects to enter into a Consent Order with the FDIC, which will require us to dedicate a significant amount of resources to comply with the order.

The Bank expects that it will enter into a Consent Order with the FDIC in the fourth quarter of 2011. While we do not know the exact contents of the Consent Order at this time, we expect that, among other things, the Consent Order could require an evaluation of management, new capital requirements, restrictions on asset growth, limitations on our ability to use brokered deposits and the interest rates we offer on deposits, and various actions to improve our asset quality and reduce the risk inherent in the Bank's loan portfolio. In addition, we could be required to develop and implement various written plans to improve oversight functions, capital, credit risk management, strategic planning and budgeting, interest rate risk, and liquidity and funds management. Certain of these provisions could adversely impact our business and the results of operations. In addition, while subject to the Consent Order, we expect that management and the board of directors will be required to focus considerable time and attention on taking corrective actions to comply with the its terms. We also expect that we may be required to hire third party consultants and advisors to assist us in complying with the Consent Order, which could increase our noninterest expense and reduce our earnings.

There is also no guarantee that the Bank will successfully address the FDIC's concerns in the anticipated Consent Order or that the Bank will be able to comply with it. If we do not comply with the anticipated Consent Order, we could be subject to further regulatory enforcement actions, which could adversely impact our business and results of operations.

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

Not applicable.

### ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

In May 2011, the Company notified the U.S. Treasury that the Company was going to defer the payment of the quarterly cash dividend of \$184,225 due on May 16, 2011, and subsequent quarterly payments, on the Fixed Rate Cumulative Perpetual Preferred Stock, Series A. The total arrearage on such preferred stock as of the date of this filing is \$464,458.

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

101 The following materials from the Village Bank and Trust Financial Corp. Quarterly Report on Form 10-Q for the quarter ended September 30, 2011 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Stockholders' Equity, (iv) Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements.

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: November 14, 2011

By: /s/ Thomas W. Winfree  
Thomas W. Winfree  
President and Chief Executive Officer

Date: November 14, 2011

By: /s/ C. Harril Whitehurst, Jr.  
C. Harril Whitehurst, Jr.  
Chief Financial Officer

Exhibit Index

Exhibit Number	
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 Certification of Chief Financial Officer

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