

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

(Mark One)

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

Bank of McKenney

(Exact name of registrant as specified in its charter)

Virginia

State or other jurisdiction of
incorporation or organization

54-0132540

(I.R.S. Employer
Identification No.)

20718 First Street, McKenney, Virginia

(Address of principal executive offices)

23872

(Zip Code)

Registrant's telephone number, including area code: **(804) 478-4434**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

Common Stock, \$2.00 par value per share

The NASDAQ Capital Market

Securities registered pursuant to section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. **\$12,268,825 based on 06/30/08 close of \$7.01**

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. **1,926,656 shares as of March 9, 2009**

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement to be used in conjunction with the registrant's 2008 Annual Meeting of Shareholders are incorporated into Part III of this Form 10-K.

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SIGNATURES

This Form 10-K contains, in addition to historical information, various “forward-looking statements” that represent the Bank’s judgment concerning the future. For this purpose any statements contained in this Form 10-K that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, words such as “may,” “will,” “expect,” “believe,” “anticipate,” “estimate” or “continue” or comparable terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties, and actual operating results and financial position may differ materially depending on a variety of factors about which the Bank is unable to predict. In this report, we frequently use the terms “we”, “our” and “us” to refer to Bank of McKenney and our subsidiary.

PART I.

Item 1. Business

General

Bank of McKenney (the “Bank”) is a Virginia chartered community bank that was established in 1906 and is headquartered in McKenney, Virginia. We provide customized banking solutions to small and medium sized businesses, professionals and individuals in Dinwiddie, Prince George and Chesterfield counties and the cities of Colonial Heights, Hopewell and Petersburg. In addition, we attract customers from portions of Sussex, Nottoway and Brunswick counties. We offer a full range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, credit cards, commercial and residential real estate and consumer loan services, and safekeeping services.

Since our current management team was put in place in 1989, we have experienced significant growth. The Bank has grown from \$20 million in assets in 1989 to approximately \$165 million at December 31, 2008, and our shareholders’ equity has grown from approximately \$700,000 in 1989 to \$17.4 million at 2008 year’s end. Furthermore, we have paid an annual dividend for at least the last 43 years. The Bank is a publicly traded company with its securities listed on the Nasdaq Capital Market under the symbol “BOMK”.

The primary source of our revenue is interest income and fees generated by lending and investing funds on deposit. We typically balance the loan and investment portfolio towards loans. Loans generally earn more attractive returns than investments and are a key source of product cross sales and customer referrals. Certain economic conditions, such as poor regional corporate earnings, real estate cycles and other general slowing economic conditions may favor investments over loans. These conditions may lead to weaker fundamental performance. Our loan and investment strategies balance the need to maintain adequate liquidity through excess cash or federal funds sold with opportunities to appropriately leverage our capital.

As a community-oriented and locally-owned institution, we invest our loan resources in the community and tailor our services to meet the banking and financial needs of our customers who live and do business in the communities we serve. We strive to serve the banking needs of our customers by developing and maintaining long-term relationships, which will sustain the economic vitality of both the community and the Bank.

By hiring experienced professional community bankers to direct our activities, we offer the personalized, efficient service that differentiates a successful “community bank” from large bank holding companies. Also, with the flexibility of our smaller size and through an emphasis on personal attention and service, we can be more responsive to the individual needs of our customers than our larger competitors.

The Bank provides non-deposit investment services, insurance products and business management solutions services to customers through McKenney Group, LLC, a wholly owned subsidiary of the Bank, formed in July 2001. The Bank also derives some fees from appraisal services.

Strategy and Philosophy

The Bank's strategic plan is directed toward enhancing franchise value and operating profitability by increasing its asset size through quality products and services, further expanding our trade area and enhancing the use of the Internet in our operations. Our present capitalization will enable us to expand our branch network and allows us to meet the borrowing needs of most of our customers. When opportunities develop that exceed our legal lending limit, we act as a conduit to other sources for such funds. This is consistent with our philosophy of acting in our customers' best interests to build relationships. Our board of directors believes that superior service and credit underwriting enables us to obtain a reasonable market share within a highly competitive market.

Our core business philosophy involves providing superior customer service to clients, with local decision makers facilitating the transactions. Our experienced executives focus on relationships with each client and bring value to all phases of a client's business and personal banking needs. To develop this strategy, our focus has been to establish relationships with key customers in the community and centers of influence that can create business opportunities. This focus on relationship banking has led to our growth and profitability.

Employees

When the Bank opened in 1906, it had one employee. That number has grown to 63 full-time equivalent employees. None of our employees are represented by any collective bargaining unit, and we believe that relations with our employees are good.

Market Area

In addition to Dinwiddie County, Prince George County, Chesterfield County and the cities of Colonial Heights, Hopewell and Petersburg, the Bank pulls customers from portions of Sussex, Nottoway and Brunswick counties. The Bank's market area is supported primarily by trade, services and manufacturing. According to 2006 census data estimates, the population of Dinwiddie County was 25,695, a 4.7% increase from 2000. The median household income in Dinwiddie County in 2005 was \$48,319, representing an increase of 16.2% over 2000. The population of the city of Colonial Heights was estimated at 17,676 in 2006, a 4.6% increase in comparison to 2000. Median household income grew to \$44,900 in 2005, representing an increase of 3.9% over that reported in 2000. The population in Chesterfield has increased 14.2% from 259,903 in 2000 to a projected 296,718 in 2006, and the median household income has grown from the 2000 level of \$58,537 to \$68,022 in 2005. Prince George County's estimated population as reported in the 2006 census data reached 36,184, a 9.3% increase from that in the 2000 report. Median household income in Prince George in 2005 was \$57,958, up 16.2% over 2000. Population in the city of Petersburg was estimated at 32,446 in 2006, a 3.8% decrease from 2000. The median household income of Petersburg in 2005 was \$30,000, representing an increase of 4.0% over 2000. In the city of Hopewell, the population estimate in 2006 had increased by 1.7% to 22,731. Likewise, the median household income was estimated in 2005 at \$34,500 as compared to the 2000 level of \$33,196.

We believe that these trends in the demographics, particularly the strong growth in southern Chesterfield County, will provide excellent opportunities for the Bank's continued expansion and long-term growth.

Lending Activities

The Bank's primary market focus is on making loans to small businesses and consumers in its local market area. In addition, we also provide a wide range of real estate finance services. Our primary lending activities are principally directed to the areas in and around our defined market region of Dinwiddie County, Prince George County, Chesterfield County and the cities of Colonial Heights, Hopewell and Petersburg. The following detail the primary lending applications and general guidelines utilized by the Bank.

Personal Installment Loans – The Bank offers various types of secured and unsecured consumer loans, including lines of credit, for personal, family or household purposes. These loans can be structured in numerous ways, from a time note to an installment note to an open-end term as related to a line of credit. A consumer's total debt service should not generally exceed 35%; however, there are instances that may warrant a higher ratio based upon other lending considerations. The underwriting standards for consumer loans include a determination of the applicant's payment history with us, if applicable, and through the credit bureau. Verification of income is made when dealing with new borrowers or on existing customers who may have changed employment and/or source(s) of reported income since their last loan.

Commercial Real Estate Lending – Bank of McKenney primarily finances commercial real estate that is located within our market area. Our underwriting targets not only the valuation of the property but also the creditworthiness of the borrowers/guarantors and a cash flow analysis. By carefully underwriting commercial real estate loans and adhering to our loan-to-value margins of 80% or less when warranted, we are able to mitigate risk inherent with sudden or gradual drops in market values attributable to economic conditions.

Residential Real Estate Loans – Bank of McKenney offers permanent real estate loans along with equity loan products that are maintained within our portfolio. Additionally, the Bank has a "fixed rate" loan department that can offer various types of loan products that are originated under the Bank's name but are closed in the name of the lender that will do the permanent financing. The Bank's permanent financing is available in the form of a balloon loan with a rate lock of 3 to 5 years amortized up to 30 years. Home equity lines of credit have become a very popular source of financing in recent years. Typically, we consider up to 80% of the appraised value of an existing home, or the purchase price, whichever is less, and take from that any existing mortgage balance in order to ascertain the "lendable equity". This product is targeted for the customer with excellent credit history. Second mortgages are available as well. Again, the Bank generally considers 80% loan-to-value ("LTV"), based upon appraised/market value and balance of the existing mortgage. The maximum amortization is 20 years with 3 to 5 year rate locks. There are times when exceptions to the 80% LTV policy are warranted and justifiable. In those cases, the exception to go as high as 90% LTV must be approved through our Credit Committee.

Real Estate Construction Lending – This portion of our loan portfolio is primarily residential and is comprised of loans with short durations. The usual maturity on a loan of this nature is 12 months or less. Interest is typically paid monthly on the outstanding balance until it is converted to a permanent mortgage. The Bank will advance up to 80% of the appraised value of the completed project based upon plans and specifications. Our policy is to have a draw schedule established and after inspections and title policy updates and mechanics lien waivers, the advance is made, based upon the percentage of work completed. A critical part of construction lending is to ensure that the borrower has arranged a "take-out" via a permanent mortgage upon completion. We are fortunate in that we can provide the permanent financing, if the borrower so chooses, either "in-house" or through our Fixed Rate Mortgage Department as described earlier.

Credit Policies – The Bank utilizes a comprehensive online written loan policy and related procedures to enhance management of credit risk. The loan policy was enhanced during 2008 with the assistance of an outside consultant, Credit Risk Management (“CRM”), and transitioned into an online environment. In doing so, policies, procedures and regulations were all integrated together to ensure each product offered to borrowers is handled uniformly and complies with both regulatory and internal guidelines. The loan policy is reviewed at least annually by the board of directors and may change if there are significant changes in:

- the local or national economy;
- money market conditions;
- the Bank’s financial condition or loan portfolio mix;
- competitive conditions; or
- noted unstableness in any industry.

The purpose of the detailed online loan policy is to establish readily accessible guidelines for lending which are broad enough to allow the loan officer to function properly within certain known parameters. Its intent is also to be specific enough to make it clear that certain loan situations are to be avoided while others are to be encouraged. Moreover, its purpose is to establish and integrate loan procedures, outline basic credit criteria, provide adequate tools necessary to assess creditworthiness and repayment ability, and specify desirable and undesirable loan categories. The policy does not discriminate against any person because of race, color, creed, sex or age.

As a general philosophy, it is important to the Bank that loan officers do not accept loans where there is poor cash flow and the collateral value is not sufficient enough to secure the loan. The Bank’s loan objectives and lending conditions are consistent with the following:

- deposit growth – attracting new customers;
- preserving present deposits – honoring old Bank relationships;
- maximizing profitability of the Bank’s earning assets;
- safety of principal;
- serving the credit needs of the Bank’s primary service area;
- the Bank’s liquidity;
- the loan portfolio mix; and
- loans that stimulate economic growth in the primary service area are preferred over personal investment type loans.

The loan making process includes formulation of portfolio management strategy, guidelines for underwriting standards and risk assessment, procedures for ongoing identification and management of credit deterioration, and regular portfolio reviews to estimate loss exposure and ascertain compliance with the Bank’s policies. Lending authority is granted to individual lending officers, with the current highest limit being \$175,000 for either secured or unsecured loans. Loan amounts and/or total aggregate relationship liability above \$300,000 must be reviewed by the Credit Officer and any questions or concerns resolved prior to closing. An Officer’s Loan Committee comprised of all senior loan officers of the Bank must approve all loan amounts and/or aggregate relationship liability above \$500,000 and up to \$750,000. Such approval requires positive action by three or more members. The Director’s Loan Committee, consisting of the entire board of directors, meeting monthly, can approve loans over \$750,000, requiring at least three members to be present in order to act. The Bank’s legal lending limit for loans to one borrower was \$2,775,000 as of December 31, 2008.

A major element of credit risk management is diversification and avoidance of concentrations of credit. The Bank's objective is to maintain a diverse loan portfolio to minimize the impact of any single event or set of circumstances. Concentration of credit is defined as being any loan or group of loans that exceed 25% of the Bank's capital that are to one individual, a related group of borrowers or one particular industry. The Bank also maintains strict guidelines relative to managing risk related to concentrations of credit, including:

- enhanced credit criteria;
- additional controls to minimize exposure;
- strict caps on the size of concentration; and
- increased capital and loan loss reserves to cover any increased exposure.

The Bank also purchases participations in loans from other banks from time to time, as well as sells participations to other banks to participate in loans originated by Bank of McKenney, in order to manage liquidity and to diversify its loan portfolio and effectively manage risk.

Investments and Funding

The Bank balances the liquidity needs of the organization based on loan and deposit growth via the investment portfolio and purchased funds. It is our goal to provide adequate liquidity to support the loan growth of the organization. In the event the Bank has excess liquidity, investments are used to generate positive earnings. In the event deposit growth does not fully support the organization's loan growth, a combination of investment sales, federal funds and other established borrowing avenues will be used to augment the Bank's funding position.

The investment portfolio is actively managed and a majority of its holdings are classified as "Available For Sale." Under such a classification, investment instruments may be sold as deemed appropriate by management. On a monthly basis, this portion of the investment portfolio is marked to market via equity as required by Financial Accounting Standards Board Statement of Financial Accounting Standard No. 115 ("SFAS No. 115"). Additionally, the investment portfolio is used to balance the asset and liability position of the Bank. We do invest in fixed rate or floating rate instruments as necessary to reduce our interest rate risk exposure.

The investment portfolio is also maintained to provide earnings consistent with the safety factors of quality, maturity, marketability and risk diversification. Securities purchased to accomplish these objectives are classified as "Held To Maturity" and reported at their amortized cost, as required by SFAS No. 115, when the Bank demonstrates the intent and ability to hold the assets until maturity. Securities in this category may not be sold prior to maturity unless:

- the issue's maturity or certain call date is within three months of maturity;
- at least 85% of the original principal has already been collected through scheduled or unscheduled prepayments of principal and interests;
- there is evidence of significant deterioration in the issuer's creditworthiness;
- changes in tax law that reduce or eliminate the tax-exempt status of interest on an issue;
- a major business combination or disposition occurs; and
- regulatory changes which affect the size or type of permitted issues, capital requirements that require a downsizing of such classifications, or changes in risk weights of debt securities used for regulatory risk-based capital purposes.

Recent instability in credit markets and related violent swings in yields have prompted a greater focus on this category to manage our balance sheet when available funding sources are ample to meet the liquidity needs of the current and foreseeable future. The Bank has elected to so classify certain recent purchases as Held to Maturity, and near-term future purchases are likely to be classified in this manner as well until credit markets return to more normal conditions.

Deposit Activities

Deposits are the major source of funding for the Bank. We offer a broad array of deposit products that include demand, NOW, certificates of deposit, money market and savings accounts. We typically pay a competitive rate on the interest bearing deposits; however, we may become slightly more or less competitive in our interest rate structure as our liquidity position changes. As a relationship-oriented organization, we seek generally to obtain deposit relationships with our loan clients.

The Bank is a member of the “Certificate of Deposit Account Registry Services” (“CDARS”) network. Through this network, we are able to offer greater security to a larger depositor by dividing funds for larger accounts into smaller fully insurable blocks invested at adequately capitalized community banks across the country. In an amount equal to the funds of the large depositor, the Bank receives numerous insurable blocks from clients of other member banks. These reciprocal relationships are categorized as brokered deposits.

Competition

We operate in highly competitive environments in our market areas, competing for deposits and loans with major regional and national banks, as well as other financial institutions, many of which have greater financial resources than we do. Most maintain numerous banking locations and many perform services, such as trust services, that we do not offer. Additionally, many of these competitors have higher lending limits than we do. We have been able to compete effectively with other financial institutions by:

- emphasizing personal relationship banking;
- establishing long-term customer relationships;
- building customer loyalty;
- providing products and services designed to address the specific needs of our customers; and
- promoting local management and decision making in our marketing strategies.

Parts of our primary service market are highly competitive and heavily branched. Competition for loans to small and medium sized businesses, individuals and professionals, is intense, and pricing is important. Most of our competitors have substantially greater resources and lending limits than we do and offer services, such as extensive and established branch networks and trust services that we do not expect to provide in the near future. Moreover, larger institutions operating in our primary service area have access to borrowed funds at a lower rate than is available to us. Deposit competition is strong among institutions in our primary service area. As a result, it is possible that we may, to remain competitive, pay above-market rates for deposits. Despite strong competition, we are experiencing success in our primary service area because of the region’s growth rate and the area reacting favorably to our community focus and our emphasis on service to the small and medium sized business community, individuals and professionals.

Recent mergers of other area banks into large regional and national financial institutions have created opportunities for community focused and prudently managed community banks. While our board is aware of the competition that these larger institutions offer, we believe that local independent banks play a significant factor in our primary market area. Our board of directors believes it is a significant and distinct advantage to be a community owned and operated state bank interested exclusively in small and medium sized businesses, professionals and the citizens of Dinwiddie County, Prince George County, Chesterfield County, the city of Colonial Heights, city of Hopewell, city of Petersburg and adjacent areas.

Supervision and Regulation

General

We are organized as a Virginia-chartered community bank and are regulated and supervised by the Virginia Bureau of Financial Institutions. In addition, we are regulated and supervised by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), which serves as our primary federal regulator. The Virginia Bureau of Financial Institutions and the Federal Reserve conduct regular examinations of the Bank, reviewing the adequacy of our loan loss reserves, the quality of our loans and investments, the propriety of management practices, compliance with laws and regulations, and other aspects of our operations.

Federal and Virginia banking laws and regulations govern all areas of our operations, including reserves, loans, mortgages, capital, issuances of securities, payment of dividends and establishment of branches. Federal and state bank regulatory agencies also have the general authority to limit the dividends paid by Federal Deposit Insurance Corporation-insured banks. The Federal Reserve and the Federal Deposit Insurance Corporation (the "FDIC") have authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent the Bank from engaging in unsafe or unsound practices. In this regard, the Federal Reserve and the FDIC have adopted capital adequacy requirements, which apply to us.

FDIC Deposit Insurance

The FDIC insures the deposits of the Bank up to the limits set forth under applicable law. On February 15, 2006, federal legislation to reform federal deposit insurance was enacted. The new law merged the old Bank Insurance Fund and Savings Association Insurance Fund into the single Deposit Insurance Fund (the "DIF"), increased deposit insurance coverage for IRAs to \$250,000, provided for the further increase of deposit insurance on all accounts by indexing the coverage to the rate of inflation, authorized the FDIC to set the reserve ratio of the DIF at a level between 1.15% and 1.50%, and permits the FDIC to establish assessments to be paid by insured banks to maintain the minimum ratios. In 2007, the FDIC adopted regulations establishing a risk-based assessment system that is intended to more closely tie each bank's deposit insurance assessments to the risk it poses to the DIF. Under the risk-based assessment system, the FDIC will evaluate each bank's risk based on three primary factors: (1) its supervisory rating, (2) its financial ratios, and (3) its long-term debt issuer rating, if the bank has one.

On December 16, 2008, the FDIC approved the attached final rule on deposit insurance assessment rates for the first quarter of 2009. The rule raises assessment rates uniformly by 7 basis points (annual rate) for the first quarter of 2009 only as follows.

	Risk Category				
	I		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points)	12	14	17	35	50

The ruling also established risk-based assessment rates for the period immediately following the first quarter of 2009. The following table shows the tiers of assessment rates to be applied beginning with the second quarter of 2009.

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial Base Assessment Rate	12 – 16	20	30	45
Unsecured Debt Adjustment (added)	(2) to 0	(2) to 0	(2) to 0	(2) to 0
Secured Liability Adjustment (added)	0 to 7	0 to 10	0 to 15	0 to 22.5
Brokered Deposit Adjustment (added)	N/A	0 to 10	0 to 10	0 to 10
Total Base Assessment Rate	10 to 23	18 to 40	28 to 55	43 to 77.5

Other key highlights of the final rule are:

- *Risk-Based Assessments for Risk Category I:* To determine initial base assessment rates, the FDIC proposes to: (1) introduce a new financial ratio into the financial ratios method applicable to most Risk Category I institutions to include brokered deposits above a threshold that are used to fund rapid asset growth; (2) for a large Risk Category I institution with long-term debt issuer ratings, combine weighted average CAMELS component ratings, the debt issuer ratings, and the financial ratios method assessment rate; and (3) use a new uniform amount and pricing multipliers for each method.
- *Adjustments to Assessment Rates:* The FDIC also proposes to introduce three adjustments that could be made to an institution's initial base assessment rate: (1) a potential decrease for long-term unsecured debt, including senior and subordinated debt and, for small institutions, a portion of Tier 1 capital; (2) a potential increase for secured liabilities above a threshold amount; and (3) for non-Risk Category I institutions, a potential increase for brokered deposits above a threshold amount.

The FDIC will issue another final rule early in 2009, to take effect on April 1, 2009, to change the way that the FDIC's assessment system differentiates for risk, make corresponding changes to assessment rates beginning with the second quarter of 2009, and make certain technical and other changes to the assessment rules.

On March 2, 2009, the FDIC set the new rate under which most insured institutions will be assessed between 12 and 16 basis points before certain adjustments, effective the second quarter. More importantly, FDIC adopted an interim rule setting a special assessment of 20 basis points for June 30, 2009, to be collected September 30, 2009. This interim rule is open for comment for a period thirty days after publication in the Federal Register. Subsequent communications have indicated this special assessment may be lowered to 10 basis points in the event the FDIC's line of credit through the Treasury Department is increased from \$30 billion to \$100 billion. Discussions are ongoing at this time.

The new assessment rates for most banks will vary between twelve and fourteen cents for every \$100 of domestic deposits for the first quarter of 2009 and a rate varying between ten and twenty-three cents for the remaining three quarters of 2009. Applied to the Bank's assessment base of approximately \$142 million and factoring in a special assessment of between ten to twenty cents, this translates to an annual deposit premium estimated to be between \$291,100 and \$578,700. Due to the significant increase in year-over-year assessments rates, we expect a negative effect on results of operations during 2009.

Capital Requirements

The federal bank regulatory agencies have adopted risk-based capital requirements for assessing bank capital adequacy. Virginia chartered banks must also satisfy the capital requirements adopted by the Virginia Bureau of Financial Institutions. The federal capital standards define capital and establish minimum capital requirements in relation to assets and off-balance sheet exposure, as adjusted for credit risk. The risk-based capital standards currently in effect are designed to make regulatory capital requirements more sensitive to differences in risk profile among bank holding companies and banks, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Assets and off-balance sheet items are assigned to broad risk categories, each with appropriate risk weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items.

The minimum standard for the ratio of capital to risk-weighted assets (including certain off-balance sheet obligations, such as stand-by letters of credit) is 8.00%. At least half of the risk-based capital must consist of common equity, retained earnings and qualifying perpetual preferred stock less deductions for goodwill and various other tangibles ("Tier 1 capital"). The remainder ("Tier 2 capital") may consist of a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, preferred stock and a limited amount of the general valuation allowance for loan losses. The sum of Tier 1 capital and Tier 2 capital is "total risk-based capital." The Federal Reserve has also adopted regulations that supplement the risk-based guidelines to include a minimum leverage ratio of Tier 1 capital to quarterly average assets of 4.00%. At December 31, 2008, we had the following risk-based capital and leverage ratios relative to regulatory minimums:

<u>Ratio</u>	<u>Bank of McKenney</u>	<u>Minimum</u>
Tier 1 risk-based capital	14.36%	4.00%
Total risk-based capital	15.09%	8.00%
Leverage	11.33%	6.00%

The Federal Reserve is authorized by federal legislation and regulations to take various enforcement actions against any undercapitalized insured depository institution and any insured depository institution that fails to submit an acceptable capital restoration plan or fails to implement a plan accepted by the FDIC. These powers include, among other things, requiring a bank to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions, requiring divestiture by the institution of its subsidiaries, requiring new election of directors, and requiring the dismissal of directors and officers.

Dividends

The amount of dividends payable by us depends upon our earnings and capital position and is limited by the federal and state law, regulations and policy. In addition, Virginia law imposes restrictions on the ability of all banks chartered under Virginia law to pay dividends. No dividend may be declared or paid that would impair a bank's paid-in capital. The Virginia Bureau of Financial Institutions and the FDIC have the general authority to limit dividends paid by the Bank if such payments are deemed to constitute an unsafe and unsound practice. In particular, Section 38 of the Federal Deposit Insurance Act would prohibit the Bank from making a dividend if it were "undercapitalized" or if such dividend would result in the institution becoming "undercapitalized."

Community Reinvestment Act

Banks are subject to the provisions of the Community Reinvestment Act of 1977 (the "CRA") that requires the appropriate federal bank regulatory agency, the Federal Reserve in our case, to assess our record in meeting the credit needs of the communities we serve. The Federal Reserve's assessment of our record is publicly available. The CRA assessment is required by any bank that has applied to, among other things, establish a new branch office that will accept deposits, relocate an existing office, or merge, consolidate with or acquire the assets or assume the liabilities of a federally regulated financial institution. We received an "Outstanding" rating in our last CRA exam in July 2007.

Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act of 1999 implemented major changes to the statutory framework for providing banking and other financial services in the United States. The act, among other things, eliminated many of the restrictions on affiliations among banks and securities firms, insurance firms, and other financial service providers. A bank holding company qualifying as a financial holding company will be permitted to engage in activities that are financial in nature or incidental or complimentary to a financial activity. The activities that the act expressly lists as financial in nature include insurance activities, providing financial and investment advisory services, underwriting services and limited merchant banking activities. To become eligible for these expanded activities, a bank holding company must qualify as a financial holding company. We presently have no plans to form a bank holding company or to become a financial holding company.

The act also provided new protections against the transfer and use by financial institutions of consumers' nonpublic personal information. A financial institution must provide to its customers, at the beginning of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. The privacy provisions generally prohibit a financial institution from providing a customer's personal financial information to unaffiliated third parties unless the institution discloses to the customer that the data may be so provided and the customer is given the opportunity to opt out of such disclosure.

Although considered to be one of the most significant banking laws since Depression-era statutes were enacted, we do not expect the Gramm-Leach-Bliley Act to materially affect our products, services or other business activities. To the extent that it allows banks, securities firms, and insurance firms to affiliate, the financial services industry may experience further consolidation. The act may have the result of increasing the amount of competition that we face from larger institutions and other companies offering financial products and services, many of which may have substantially more financial resources.

USA Patriot Act of 2001

In October, 2001, the USA Patriot Act of 2001 (the “Patriot Act”) was enacted in response to the terrorist attacks in New York, Pennsylvania and Northern Virginia which occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcements’ and the intelligence communities’ abilities to work cohesively to combat terrorism on a variety of fronts. The continuing and potential impact of the Patriot Act and related regulations and policies on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Check 21

On October 28, 2003, President Bush signed into law the Check Clearing for the 21st Century Act, also known as Check 21. Check 21 gives “substitute checks,” such as a digital image of a check and copies made from that image, the same legal standing as the original paper check. Some of the major provisions of Check 21 include:

- allowing check truncation without making it mandatory;
- demanding that every financial institution communicate to accountholders in writing a description of its substitute check processing program and their rights under the law;
- legalizing substitutions for and replacements of paper checks without agreement from consumers;
- retaining in place the previously mandated electronic collection and return of checks between financial institutions only when individual agreements are in place;
- requiring that when accountholders request verification, financial institutions produce the original check (or a copy that accurately represents the original) and demonstrate that the account debit was accurate and valid; and
- requiring re-crediting of funds to an individual’s account on the next business day after a consumer proves that the financial institution has erred.

Emergency Economic Stabilization Act of 2008

In accordance with its stated purpose of restoring liquidity and stability to the financial system of the United States, the Emergency Economic Stabilization Act of 2008 (“EESA”) established the Troubled Asset Relief Program (“TARP”), under which the U.S. Department of the Treasury (the “Treasury”) is authorized to purchase preferred stock from qualified financial institutions. The Bank meets the requirements to be considered a qualified financial institution. Under TARP, for organizations like the Bank, the federal government’s purchase limitation is generally defined as 3% of risk-weighted assets. The terms of the preferred stock generally provide that:

- cumulative dividends will be paid at a rate of 5% for the first five years and 9% thereafter;
- any increase in the dividend rate paid on common stock during the first three years will require the consent of the Treasury;
- any repurchase of common stock will require the consent of the Treasury;
- conditions and limitations will be placed on executive compensation; and
- the Treasury will receive warrants, with a term of 10 years, to purchase a number of shares of common stock having an aggregate market price equal to 15% of the preferred stock amount on the day of investment.

We considered several factors in deliberating the appropriateness of applying under the Treasury’s capital purchase plan. These factors included the following:

- capital position
- asset quality
- liquidity level
- public perception
- resulting government oversight and restrictions

In light of these factors, at the current time, we have deemed it not appropriate to apply for funding under the Treasury’s capital purchase program.

Effect of Governmental Monetary Policies

Our operations will be affected not only by general economic conditions but also by the policies of various regulatory authorities. In particular, the Federal Reserve regulates money, credit conditions and interest rates in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of bank loans, investments and deposits and affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to do so in the future.

Reporting Obligations under Securities Laws

The Bank is subject to the periodic reporting requirements of the Securities Exchange Act of 1934 as amended (the “Exchange Act”), as adopted by the Federal Reserve, including the filing of annual, quarterly and other reports with the Federal Reserve. As an Exchange Act reporting bank, the Bank is directly affected by the Sarbanes-Oxley Act of 2002 and regulations promulgated therein, which are aimed at improving corporate governance and reporting procedures. The Bank is complying with the rules and regulations implemented pursuant to the Sarbanes-Oxley Act and intends to comply with any applicable rules and regulations implemented in the future.

Other Regulations

Interest and other charges collected or contracted for by the Bank are subject to state usury laws and federal laws concerning interest rates. The Bank’s loan operations are also subject to federal laws applicable to credit transactions, such as:

- the federal Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- the Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- the Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- the Fair Credit Reporting Act of 1978, governing the use and provision of information to credit reporting agencies;
- the Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies; and
- the rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

In addition, the deposit operations of the Bank are subject to:

- the Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records; and
- the Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve Board to implement that Act, which govern automatic deposits to and withdrawals from deposit accounts and clients’ rights and liabilities arising from the use of automated teller machines and other electronic banking services.

Item 1A. Risk Factors

Not applicable to smaller reporting companies.

Item 1B. Unresolved Staff Comments

Not applicable to smaller reporting companies.

Item 2. Properties

The Bank's Headquarters office is located at 20718 First Street in McKenney, Virginia. The Bank, at present, has six branch locations throughout south central Virginia:

- the Airport Branch, located in the northern end of Dinwiddie County;
- the Dinwiddie Branch located in central Dinwiddie County;
- the Matoaca Branch, located in southern Chesterfield County;
- the McKenney Branch, located in southern Dinwiddie County in the town of McKenney;
- the Colonial Heights Branch, located in the city of Colonial Heights; and
- the Prince George Branch located in western Prince George County near the city of Hopewell.

All of our permanent facilities and branch locations are owned. The Bank also owns four pieces of marketable property acquired in the ordinary course of our business. We believe that the natural evolution of a community bank like Bank of McKenney is to expand delivery of our core products and services through our branch network. Accordingly, in the future we may take advantage of strategic opportunities presented to us by pursuing key market locations for new branches in our market area affected by recent bank mergers, struggling bank start-ups, or in those regions which tend to be overlooked by our larger competitors.

Item 3. Legal Proceedings

In the ordinary course of its operations, the Bank is a party to various legal proceedings. Based upon information currently available, management believes that such legal proceedings, in the aggregate, will not have a material adverse effect on the business, financial condition, or results of operations of the Bank.

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

No matters were submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders of the Bank through a solicitation of proxies or otherwise.

PART II.

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity

The Bank's common stock trades on the Nasdaq Capital Market under the symbol "BOMK". There were 1,926,656 shares of the Bank's stock issued and outstanding at the close of business on December 31, 2008, which were held by approximately 419 shareholders of record. The closing price of the Bank's stock on December 31, 2008 was \$6.99 per share as compared to \$10.25 on December 31, 2007.

The following table summarizes the high and low sales prices and dividends declared for the two years ended December 31, 2008.

	Market Values				Dividends Declared	
	2008		2007		2008	2007
	High	Low	High	Low		
First Quarter	\$11.01	\$ 7.59	\$11.53	\$10.20	\$ -	\$ -
Second Quarter	9.96	6.69	10.62	9.55	-	-
Third Quarter	8.40	4.54	10.50	8.24	-	-
Fourth Quarter	8.00	5.25	11.00	8.75	0.27	0.27

Item 6. Selected Financial Data

The summary financial data should be read in conjunction with the historical financial statements and the notes thereto included elsewhere in this document.

	Period Ended December 31,				
	2008	2007	2006	2005	2004
	(Dollars in Thousands, except per share and share information)				
Income Statement Data:					
Interest income	\$ 10,025	\$ 9,853	\$ 9,123	\$ 7,882	\$ 7,085
Interest expense	3,949	4,030	3,334	2,294	1,742
Net interest income	6,076	5,823	5,789	5,588	5,343
Provision for loan losses	358	82	46	41	102
Non-interest income	1,863	1,623	1,470	1,429	1,429
Non-interest expense	5,886	5,514	5,375	5,047	4,844
Income taxes	443	557	571	606	577
Net income	\$ 1,252	\$ 1,293	\$ 1,267	\$ 1,323	\$ 1,249
Per Share and Shares Outstanding Data:					
Basic net income	\$ 0.65	\$ 0.67	\$ 0.66	\$ 0.69	\$ 0.65
Fully diluted net income	0.65	0.67	0.66	0.69	0.65
Cash dividends declared	0.27	0.27	0.35	0.22	0.20
Book value at period end	9.01	9.38	8.78	8.19	7.97
Shares outstanding, period end	1,926,656	1,926,656	1,926,656	1,926,656	1,926,656
Average shares outstanding, basic	1,926,656	1,926,656	1,926,656	1,926,656	1,926,656
Average shares outstanding, diluted	1,926,656	1,926,656	1,926,656	1,926,656	1,926,656
Balance Sheet Data:					
Total assets	\$ 165,462	\$ 161,191	\$ 151,879	\$ 142,202	\$ 132,271
Total loans, net	110,649	107,028	100,902	93,294	92,708
Total investment securities	30,744	30,082	29,191	26,303	21,240
Total interest-bearing time deposits in other banks	1,540	--	--	3,015	--
Total deposits	142,893	127,519	119,262	110,663	111,070
Total borrowed funds	3,333	13,667	14,000	14,348	4,702
Shareholders' equity	17,368	18,069	16,918	15,782	15,364
Performance Ratios:					
Return on average assets	0.76%	0.83%	0.86%	0.95%	0.97%
Return on average equity	6.88%	7.29%	7.64%	8.35%	8.24%
Net interest margin ⁽¹⁾	4.14%	4.19%	4.38%	4.54%	4.69%
Asset Quality Ratios: ⁽²⁾					
Allowance to period-end loans	1.02%	0.86%	1.05%	1.09%	1.07%
Non-performing assets to total loans	1.58%	1.28%	1.53%	1.86%	1.71%
Capital Ratios:					
Tier I risk-based capital	14.36%	15.52%	15.30%	15.99%	15.35%
Total risk-based capital	15.09%	16.19%	16.08%	16.79%	16.14%
Leverage capital ratio	11.33%	11.34%	11.41%	11.33%	11.70%

⁽¹⁾ Net interest income divided by total average earning assets.

⁽²⁾ Non-performing assets consist of nonaccrual loans, restructured loans and foreclosed properties.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Critical Accounting Policies

The Bank's financial statements are prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). The financial information contained within our statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or on credit watch (marginal but not presently considered substandard). For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependant.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures.

In preparing consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses.

Overview

For the year ended December 31, 2008, net income amounted to \$1,252,000 compared to net income of \$1,293,000 for the same period in the prior year. Basic and diluted earnings per share were \$0.65 for the year ended December 31, 2008 compared to the prior year earnings per share of \$0.67 per common share. Weighted average shares outstanding for both periods equaled 1,926,656. The 3.17% decrease in earnings is primarily attributable to the current economic uncertainties within major sectors of the credit markets which have prompted significant build ups of loss reserves for potential borrower defaults. Return on average equity for the period ended December 31, 2008 was 6.88% compared to 7.29% in 2007. Return on average assets for the period ended December 31, 2008 was 0.76% compared to 0.83% in 2007.

Total assets amounted to \$165.5 million on December 31, 2008, an increase of 2.67% or \$4.3 million over the December 31, 2007 level of \$161.2 million. Total loans, as of December 31, 2008, grew to \$111.8 million compared to \$107.0 million as of December 31, 2007. The loan portfolio was up \$4.8 million or 4.49% over the December 31, 2007 level. At year-end 2008, the investment portfolio stood at \$30.7 million, which represents a 1.99% increase over the \$30.1 million prior year-end balance. On December 31, 2008, interest-bearing time deposits in other banks stood at \$1.5 million. There were no interest-bearing time deposit investments as of December 31, 2007. Overnight federal funds sold decreased \$6.7 million, or 88.16%, from \$7.6 million on December 31, 2007 to \$0.9 million on December 31, 2008. Cumulatively, these earning assets grew \$0.2 million or 0.14% during 2008 and represent 86.10% of total assets.

The allowance for loan losses was \$1,135,000 as of December 31, 2008 or 1.02% of loans outstanding, compared to \$925,000 as of December 31, 2007 or 0.86% of outstanding loans. The increased reserves resulted from higher than normal pressures being experienced by borrowers. These pressures created increases in past due and impairment percentages as well as historically high charge-off situations during 2008. The reserve analysis at year's end proved the balance adequate under current local economic conditions, historic experience and the increase in impaired debts; however, continued building of loss reserves will be emphasized during this economic downturn. The Bank works diligently to maintain quality in its loan portfolio and has historically maintained a delinquency ratio below 1%.

Total deposits amounted to \$142.9 million as of December 31, 2008, which represents a \$15.4 million or 12.08% increase from the \$127.5 million level as of December 31, 2007. Total noninterest-bearing demand deposits were \$26.1 million as of December 31, 2008, an increase of \$1.8 million or 7.41% over the December 31, 2007 level. During this same period, interest-bearing deposits climbed \$13.6 million or 13.18% from \$103.2 million to \$116.8 million.

Total borrowings from the Federal Home Loan Bank of Atlanta (the "FHLB") decreased \$10.4 million from \$13.7 million on December 31, 2007 to \$3.3 million as of December 31, 2008. The Bank utilized the strength experienced in core deposits to repay a \$10 million fixed rate debt prior to its 2015 maturity and reduce overall cost of funds. Volatile rate swings resulting from the freezing of credit markets presented opportunities to repay this debt with insignificant penalty. There was no additional borrowing through the FHLB during 2008.

Total shareholders' equity was \$17.4 million as of December 31, 2008 and \$18.1 million as of December 31, 2007. The decrease in equity stemmed from net unrealized losses in the Bank's available for sale ("AFS") investment portfolio and recorded in equity as other comprehensive losses. The Bank's common stock trades on the Nasdaq Capital Market under the symbol "BOMK".

The Bank's net interest margin was 4.14% for the year ended December 31, 2008 as compared to 4.19% for same period in 2007. The pace of the decrease in the net interest margin slowed greatly in the second half of 2008; however, the Federal Reserve's Federal Open Market Committee drastically cut rates paid for overnight funds to help avoid a complete collapse in credit markets and an extended, worsening economic recession. These drastic rate reductions are being reflected through both declining yields on loans as well as a falling cumulative cost of funds rate. In the immediate near-term, a slight further erosion of the margin may occur. Nevertheless, the lower deposit rates are expected to offset and stabilize this effect.

The Bank is not aware of any current recommendations by any regulatory authorities which, if implemented, would have a material effect on the Bank's liquidity or capital resources. However, the pending potential FDIC special assessment may materially affect the results of operations for 2009.

Results of Operations

Net Interest Income. The net interest income for the year ended December 31, 2008 was \$6.1 million, a 5.17% increase when compared to the December 31, 2007 level of \$5.8 million. The average loan portfolio increased \$5.3 million to \$109.9 million for the current fiscal year, representing a 5.07% hike over the average loan portfolio assets of \$104.6 million for the same period in 2007. Average investments climbed \$3.2 million to \$31.4 million for the current fiscal year, representing an 11.35% rise over the prior year's average investment portfolio of \$28.2 million in 2007. Average demand deposits increased during 2008 to \$24.8 million as compared to \$23.8 million for the same period in 2007. Average interest-bearing deposits were \$111.1 million through the year ended December 31, 2008, and represented an increase of \$12.5 million or 12.68% over the average 2007 level of \$98.6 million. Finally, average borrowed funds decreased \$4.1 million from the December 31, 2007 level of \$13.8 million to the December 31, 2008 level of \$9.7 million.

Interest expense for all interest bearing liabilities amounted to \$3.9 million in 2008, which was 2.50% or \$100,000 less than the 2007 level of \$4.0 million. Cost of interest bearing liabilities was 3.26% during 2008 or 32 basis points lower than the 2007 level of 3.58%, the decrease being attributable to the effects of extensive rate reductions by the Federal Reserve throughout the year.

The table on the following page compares the average balances of key asset and liability categories from 2008 to 2007. Average loan balances were \$109.9 million in 2008 as compared to \$104.6 million in 2007. The related interest income from loans was \$8.3 million in 2008 equaling the related income of 2007. The average yield on loans decreased from 7.91% in 2007 to 7.55% in 2008. The investment securities and other earning assets (such as federal funds sold) contributed \$1.8 million to the interest income level of \$10.1 million in 2008. These assets earned \$1.6 million in 2007. The yield on earning assets was 6.80% in 2008 and 7.08% in 2007. Consistent with asset growth the average interest bearing funding sources (deposit and purchased funds) grew to \$121.1 million in 2008, which was \$8.7 million, or 7.74% greater than the 2007 level of \$112.4 million. The interest spread modestly expanded for the twelve months of 2008 by 4 basis points to 3.54%. Nevertheless, the net interest margin decreased for the twelve months of 2008 to 4.14% from 4.19% for the same period in 2007. The decrease in the net interest margin has been primarily credited to the cyclical nature of the deposit sector which is adjusting steadily lower as issues mature and re-price. A large segment of the loan portfolio is prime based and, as such, adjusts immediately causing short term margin pressure. The growth in interest spread, a more forward looking indicator, points to margin stabilization and expansion as the deposit cycle continues and further reduces cost of funds. This will be further fostered by the Bank's investment portfolio which was reorganized in the second quarter to include extremely attractive, investment grade corporate debt issues.

The following table illustrates average balances of total interest earning assets and total interest bearing liabilities for the periods indicated, showing the average distribution of assets, liabilities, shareholders' equity and related income, expense and corresponding weighted average yields and rates. The average balances used in these tables and other statistical data were calculated using daily average balances.

Average Balances, Interest Income and Expense and Average Yields and Rates

	Period Ended December 31,					
	2008			2007		
	Average Balance	Income / Expense	Yield / ⁽¹⁾ Rate	Average Balance	Income / Expense	Yield / ⁽⁴⁾ Rate
	(Dollars in Thousands)					
Assets:						
Interest earning assets:						
Investment securities ⁽²⁾	\$ 31,375	\$ 1,612	5.14%	\$ 28,169	\$ 1,272	4.52%
Loans	109,911	8,300	7.55%	104,639	8,273	7.91%
Interest bearing balances with banks	2,566	74	2.88%	490	24	4.90%
Federal funds sold	4,508	97	2.15%	6,534	326	4.99%
Total interest earning assets	148,360	10,083	6.80%	139,832	9,895	7.08%
Non-interest earning assets:						
Cash and due from banks	4,025			3,614		
Premises and equipment	8,284			6,714		
Other assets	6,078			6,142		
Less: Allowance for loan losses	(997)			(946)		
	<u>17,390</u>			<u>15,524</u>		
	<u>\$ 165,750</u>			<u>\$ 155,356</u>		
Liabilities and Stockholders' Equity						
Interest bearing liabilities:						
Interest bearing demand deposits	\$ 14,988	\$ 190	1.27%	\$ 9,705	\$ 38	0.39%
Money market deposit accounts	7,409	85	1.15%	6,715	127	1.89%
Savings accounts	11,617	69	0.59%	12,902	77	0.60%
Time deposits	77,045	3,139	4.07%	69,289	3,134	4.52%
Total interest-bearing deposits	111,059	3,483	3.14%	98,611	3,376	3.42%
Federal funds purchased	308	6	1.95%	-	-	0.00%
FHLB Advances	9,694	459	4.73%	13,832	654	4.73%
Total interest-bearing liabilities	121,061	3,948	3.26%	112,443	4,030	3.58%
Non-interest bearing liabilities:						
Demand deposits	24,793			23,803		
Other liabilities	1,691			1,385		
Total liabilities	147,545			137,631		
Shareholders' Equity	18,205			17,725		
Total Liabilities and Shareholders' Equity	<u>\$ 165,750</u>			<u>\$ 155,356</u>		
Interest Spread ⁽³⁾			3.54%			3.50%
Net Interest Margin ⁽⁴⁾		<u>\$ 6,135</u>	4.14%		<u>\$ 5,865</u>	4.19%

⁽¹⁾ Yields and rates are annualized.

⁽²⁾ Income and yields are reported on tax equivalent basis assuming a federal tax rate of 34%.

⁽³⁾ Interest Spread is the average yield earned on earning assets, less the average rate incurred on interest bearing liabilities.

⁽⁴⁾ Net interest margin is net interest income, expressed as a percentage of average earning assets.

The following table describes the impact on the Bank's interest income and expense resulting from changes in average balances and average rates for the periods indicated. The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

Net Interest Income Volume and Rate Analysis

	Years Ended December 31,		
	2008 Compared to 2007		
	Change Due To:		
	Increase/ (Decrease)	Volume	Rate
	(Dollars in Thousands)		
Interest Earning Assets:			
Investments	\$ 340	\$ 154	\$ 186
Loans	27	279	(252)
Interest bearing balances with banks	50	55	(5)
Federal funds sold	(229)	(81)	(148)
Total Increase (Decrease) in Interest Income	188	407	(219)
Interest Bearing Liabilities:			
Interest bearing deposits	107	304	(197)
Federal funds purchased	6	6	-
Borrowed funds	(195)	(195)	-
Total Increase (Decrease) in Interest Expense	(82)	115	(197)
Increase (Decrease) in Net Interest Income	\$ 270	\$ 292	\$ (22)

Interest Rate Sensitivity Analysis and Interest Rate Risk Management

The management team evaluates current interest rate sensitivity on a periodic basis. As part of the evaluation, the Bank reviews the “static” gap position of the organization. Business and pricing strategies are adjusted based upon management’s view of likely interest rate scenarios in conjunction with the current balance sheet structure.

The following table illustrates the interest sensitivity gap position of the Bank as of December 31, 2008. This table presents a position that existed at one particular day that changes continually and is not necessarily indicative of the Bank’s position at any other time. Nonaccrual loans are excluded from the loan category.

Interest Sensitivity Analysis					
December 31, 2008					
Maturing or Repricing					
	Within 3 Months	4 - 12 Months	1 - 5 Years	Over 5 Years	Total
(Dollars in Thousands)					
Interest Earning Assets:					
Investment securities	\$ 1,515	\$ 8,536	\$ 13,581	\$ 9,155	\$ 32,787
Loans	31,036	12,822	54,456	13,470	111,784
Interest bearing deposits	1,540	-	-	-	1,540
Federal funds sold	858	-	-	-	858
Total interest earning assets	34,949	21,358	68,037	22,625	146,969
Interest bearing liabilities:					
Interest bearing demand deposits	16,192	-	-	-	16,192
Money market deposit accounts	7,862	-	-	-	7,862
Savings accounts	10,905	-	-	-	10,905
Time deposits & IRAs	16,633	33,828	31,229	102	81,792
Total interest-bearing deposits	51,592	33,828	31,229	102	116,751
FHLB Advances	89	266	1,355	1,623	3,333
Total interest-bearing liabilities	51,681	34,094	32,584	1,725	120,084
Period Gap	\$ (16,732)	\$ (12,736)	\$ 35,453	\$ 20,900	\$ 26,885
Cumulative Gap	\$ (16,732)	\$ (29,468)	\$ 5,985	\$ 26,885	\$ 26,885
Cumulative Gap / Total Assets	-10.11%	-17.81%	3.62%	16.25%	16.25%

The cumulative static gap position within three months was (\$16,732,000) or -10.11% of total assets as of December 31, 2008. The negative gap suggests the organization sees a neutral to easing monetary policy and has positioned assets maturities out longer to preserve yields in comparison to liability intervals. This measurement technique is common in the financial services industry. However, it has limitations and is not the sole tool for measuring interest rate sensitivity.

On a quarterly basis, the Bank performs a complex “Interest Rate Risk Profile” using an independent third party model. This procedure provides a much more accurate measure of sensitivity by incorporating actual portfolio re-pricing data along with current and forecasted market rate environments. As of December 31, 2008, the Bank is in an asset sensitive position as expressed by the one-year cumulative “beta” adjusted gap risk ratio of +0.98%. This interest rate risk position in a declining rate cycle generally forecasts a net interest margin that moves in a direction parallel to market interest rates.

In the third quarter of 2007, the Federal Reserve began an easing cycle as a collapsing housing market and a sub-prime sector riddled with poor lending practices signaled a potential economic recession looming. This cycle was accelerated with each 2008 Federal Open Market Committee meeting lowering the overnight funds rate. By year’s end, the overnight funds and prime lending rate had fallen from 4.25% and 7.25%, respectively to 0.25% and 3.25%, respectively. Monetary policy is forecasted to remain historically low for the foreseeable future and until the credit crisis and recessionary period ends.

The Bank remains very focused on interest rate risk management. During the 2006 and 2007 years, the majority of the investment portfolio had reached maturity and was reinvested further out on the curve at substantially higher rates. During 2008, turmoil struck credit markets and opened numerous opportunities for potential investments in high-grade corporate issues at abnormally high yields. The Bank elected to reduce some of the longer term agencies and reinvest in investment grade debt of selected banks and other segments of the financial services industry. This industry, while hit the hardest by prevailing economic conditions, seemed most likely to garner support by the government for survival should the need arise. While the investment portfolio has experienced higher than normal unrealized losses on these issues, each remains ranked as investment grade with the major rating agencies. As the deposit cycle virtually concludes by the end of 2009, leaving a substantially lower cost of funds, the yield gains from the added risk assumed in the investment portfolio should begin to expand margins. Management will, however, carefully monitor the health of these companies while the credit crisis runs its course. The first decade of this century will certainly be recorded in history as one of most challenging for interest rate risk management; however, the elections by management are expected to preserve earnings during this period of unusually low monetary policy.

Noninterest Income. For the year ended December 31, 2008, noninterest income, exclusive of securities transactions, grew to \$1.61 million, representing a 3.21% increase over the 2007 level of \$1.56 million. Service charges on deposits grew 2.66% during the year and ended with a revenue increase of \$22,000 to \$850,000. Income generated by the Bank’s fixed rate mortgage department rose \$77,000 or 21.51% from \$358,000 in 2007 to \$435,000 in 2008. Income generated on bank-owned life insurance increased \$6,000 to \$128,000 during 2008 while other income declined \$48,000 from \$248,000 on December 31, 2007 to \$200,000 on December 31, 2008. This 19.35% dip in other income stems primarily from differing gains and losses recognized on sales or donation of certain fixed assets and other real estate owned during the 2008 and 2007 periods. The Bank sold its Etrick location during 2007, realizing a gain of \$57,000 on the transaction. In 2008, 1.078 acres of land adjoining its Dinwiddie location was donated to Southern Dominion Health Systems Inc (Lunenburg Medical Center), a 501(c)(3) corporation, for the purpose of erecting a new medical facility in the county seat. A book loss of \$26,000 was recognized on the donation.

Noninterest Expense. Noninterest expense in the 2008 fiscal year amounted to \$5.89 million compared to the 2007 level of \$5.51 million. The increase is directly related to expansionary activities occurring in the franchise. The largest component of noninterest expense is salaries and benefits. Salaries and benefits expense for the year ended December 31, 2008 grew \$137,000 or 4.13% to \$3.53 million. Personnel expenses increased with the addition of the full service office in Prince George, the addition of a full time financial services investment advisor and nominal annual increases in benefits costs. Occupancy and furniture and equipment costs grew \$102,000 over the 2007 level to \$865,000. Other overhead costs increased \$130,000 or 9.56% during 2008 to \$1.49 million. Other overhead costs grew in 2008 as a result of the opening of the permanent Prince George office, increases in federal deposit insurance costs and other expenses associated with growth of the Bank.

Income Taxes. For the year ended December 31, 2008, income tax expense declined \$115,000 to \$443,000, a 20.61% decrease over the 2007 level of \$558,000. The lower tax expense is directly related to the tax-exempt investment portfolio growth in 2008 as well as the tax benefit received as a result of the land donation to a qualifying 501(c)(3) corporation.

Analysis of Financial Condition

Investment Securities. Investment securities available for sale amounted to \$29.8 million as of December 31, 2008, a decrease of \$0.3 million or 1.00% in comparison to the December 31, 2007 level of \$30.1 million. Investment securities held to maturity amounted to \$1.0 million on December 31, 2008. No investment securities were classified as held to maturity on December 31, 2007.

The Bank generally classifies the majority of investment securities as available for sale under the classifications required under SFAS No. 115. This segment of the portfolio is used to manage excess liquidity and general liquidity needs as well as other rebalancing needs as required by the overall asset / liability position. The investment portfolio is also maintained to provide earnings consistent with the safety factors of quality, maturity, marketability and risk diversification. Securities purchased to accomplish these objectives are classified as held to maturity and reported at their amortized cost, as required by SFAS No. 115, when the Bank demonstrates the intent and ability to hold the assets until maturity.

The effects of unrealized gains and losses on the portfolio were an unrealized loss of \$2,171,000 at December 31, 2008 as compared to an unrealized gain of \$573,000 at December 31, 2007. The significant change in portfolio valuation is a direct result of the ongoing credit crises and its impact on certain issues contained therein.

The investment portfolio as of December 31, 2008 contains callable U.S. Agency securities, U.S. Agency mortgage backed securities, investment grade corporate debt securities, obligations of state and political subdivisions (tax-exempt municipals), Federal Reserve Bank stock, FHLB stock and other securities. The Bank does not hold any derivative instruments. The Bank's investment strategy includes investments that provide cash flows, stable "locked out" fixed rate investments and callable securities. As part of the overall Asset/Liability strategy, fixed rate securities are purchased that provide an appropriate rate of return consistent with the objective of maintaining a portfolio duration predominately with the five-year area except for tax-exempt issues where longer maturities are necessary to receive a favorable tax-equivalent yield. The Bank actively manages its portfolio duration and composition with the changing market conditions and changes in balance sheet risk management needs. Additionally, the securities may be used to pledge for certain borrowing transactions.

The two tables on the following page set forth, as of periods indicated, (1) a summary of the investment securities portfolio as of the December 31, 2008 and 2007 and (2) a summary of the contractual maturity of investment securities on an estimated fair value basis and their weighted average yield as of December 31, 2008:

Investment Portfolio Mix

	December 31,	
	2008	2007
	(Dollars in Thousands)	
Available For Sale Securities		
U.S. Government Agency Securities	\$ 12,396	\$ 22,276
U.S. Government Agency MBS	1,226	1,825
Obligations of State/Political Subdivisions	4,203	3,732
Corporate Debt Securities	11,173	975
Total Available For Sale Securities ¹	\$ 28,998	\$ 28,808
Held To Maturity Securities		
Corporate Debt Securities	\$ 956	-
Total Held To Maturity Securities ²	\$ 956	-
Restricted Securities		
FHLB & FRB Common Stock	736	1,220
Certificate of Deposit	1,540	-
Other investments	54	54
Total Restricted Securities	\$ 2,330	\$ 1,274
Total Available For Sale and Restricted Securities	\$ 32,284	\$ 30,082

¹ AFS investments at estimated fair value.

² HTM investments at current book value.

Maturities of Investment Securities

	Within		After One		After Five		After Ten Years		Total	Yield
	One Year		Year but Within Five Years		Years but Within Ten Years		After Ten Years			
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield		
(Dollars in Thousands)										
Available For Sale Securities										
US Government Agency Securities	\$ 2,058	3.25%	\$ 2,650	5.30%	\$ 7,688	5.23%	\$ -	0.00%	\$12,396	4.92%
US Government Agency MBS	-	0.00%	-	0.00%	-	0.00%	1,226	5.40%	1,226	4.31%
Obligations of State/Political Subdivisions	-	0.00%	1,693	5.18%	2,510	5.50%	-	0.00%	4,203	5.37%
Corporate debt and Other securities	-	0.00%	7,090	6.36%	4,083	5.93%	-	0.00%	11,173	5.75%
Restricted securities	1,540	3.50%	-	0.00%	-	0.00%	790	5.82%	2,330	5.82%
Total Available For Sale Securities	\$ 3,598	3.36%	\$11,433	5.94%	\$14,281	5.48%	\$ 2,016	5.56%	\$31,328	5.32%

	Within		After One		After Five		After Ten Years		Total	Yield
	One Year		Year but Within Five Years		Years but Within Ten Years		After Ten Years			
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield		
(Dollars in Thousands)										
Held To Maturity Securities										
Corporate debt and Other securities	\$ -	0.00%	\$ 956	6.09%	\$ -	0.00%	\$ -	0.00%	\$ 956	6.09%
Total Held to Maturity Securities	\$ -	0.00%	\$ 956	6.09%	\$ -	0.00%	\$ -	0.00%	\$ 956	6.09%

Contractual maturities of mortgage-backed securities (MBS) are not necessarily reliable indicators of their expected life because mortgage borrowers have the right to prepay mortgages at any time. Additionally, various issues listed above may be redeemed prior to their specified contractual maturities by their respective issuers.

Loan Portfolio. The loan portfolio was \$111.8 million as of December 31, 2008, compared to \$107.0 million as of December 31, 2007. Commercial loans represent 7.09% of the loan portfolio or \$7.9 million as of December 31, 2008. Commercial real estate loans were \$48.6 million or 43.50% of the loan portfolio at year's end. Of this category, 42.80% or \$20.8 million was invested in owner occupied commercial real estate and 57.20% or \$27.8 million in non-owner occupied relationships. Residential real estate loans (home equity and fixed rate trusts) were \$43.0 million or 38.51% of the portfolio while consumer, real estate construction and other loans make up the balance of the loan portfolio as of December 31, 2008. The mix of loans changes somewhat each year as the demand of the Bank's market area changes. Currently, the Bank's market area includes the counties of Dinwiddie, Prince George and Chesterfield as well as the cities of Colonial Heights, Hopewell and Petersburg.

The following table summarizes the loan portfolio composition by dollar amount and percentages:

Loan Portfolio Mix				
December 31,				
2008		2007		
Amount	Percentage	Amount	Percentage	
(Dollars in Thousands)				
Commercial	\$ 7,923	7.09%	\$ 7,608	7.11%
Commercial real estate	48,626	43.50%	45,470	42.48%
Real estate construction	9,833	8.80%	12,287	11.48%
Residential real estate	43,046	38.51%	39,050	36.49%
Consumer	2,356	2.10%	2,612	2.44%
Total loans	\$ 111,784	100.00%	\$ 107,027	100.00%

The following table presents the maturities or re-pricing periods of selected loans outstanding at the year ended December 31, 2008.

Loan Maturity Distribution					
December 31, 2008					
	One Year or Less	After One Year Through Five Years	After Five Years	Total	
(Dollars in Thousands)					
Commercial	\$ 4,107	\$ 3,712	\$ 104	\$ 7,923	
Real Estate	15,619	22,191	53,862	91,672	
Real Estate Construction	6,254	2,647	932	9,833	
Installment	529	1,373	41	1,943	
Credit Card Lines	413	-	-	413	
	\$ 26,922	\$ 29,923	\$ 54,939	\$ 111,784	
Loans with:					
Fixed Rates	\$ 9,515	\$ 25,469	\$ 19,348	\$ 54,332	
Variable Rates	17,407	4,454	35,591	57,452	
	\$ 26,922	\$ 29,923	\$ 54,939	\$ 111,784	

Asset Quality. The Bank believes that the key to success is to maintain high quality in the loan portfolio, the highest yielding assets of the Bank. Weekly loan meetings are held where new commercial loan requests are discussed and existing loans reviewed, closely monitored and rigorously worked in an effort to stop potential problem situations in the early stages and keep past dues at a minimum. The allowance for loan losses was \$1,135,000 as of December 31, 2008 or 1.02% of loans outstanding compared to \$925,000 as of December 31, 2007 or 0.86% of outstanding loans. The increased reserves resulted from higher than normal pressures being experienced by borrowers. These pressures created increases in past due and impairment percentages as well as historically high charge-off situations during 2008. The reserve analysis at year's end proved the balance adequate under current local economic conditions, historic experience and the increase in impaired debts; however, continued building of loss reserves will be emphasized during this economic downturn.

The following table represents an analysis of the allowance for loan losses for the periods indicated:

	December 31,	
	2008	2007
(Dollars in Thousands)		
Balance, beginning of period	\$ 925	\$ 1,070
Provision for loan losses	358	82
Chargeoffs:		
Commerical	175	122
Real estate	-	126
Consumer	9	12
Total chargeoffs	184	260
Recoveries:		
Commerical	6	17
Consumer	8	15
Total recoveries	36	33
Net chargeoffs (recoveries)	148	227
Balance, end of period	\$ 1,135	\$ 925
Allowance for loan losses to total loans	1.02%	0.86%
Net chargeoffs to average loans	0.13%	0.22%

A breakdown of the allowance for loan losses is provided in the table atop the following page. However, management of the Bank does not believe that the allowance for loan losses can be fragmented by category with any precision that would be useful to investors. The breakdown of the allowance for loan losses is based primarily upon those factors discussed above in computing the allowance for loan losses as a whole. Because all of these factors are subject to change, the breakdown is not necessarily indicative of the category of future loan losses.

Allocation of the Allowance for Loan Losses

	December 31,	
	2008	2007
(Dollars in Thousands)		
Commercial	\$ 397	\$ 278
Commercial real estate	341	185
Real estate construction	57	46
Residential real estate	227	185
Consumer	114	231
Total Allowance for Loans Losses	\$ 1,135	\$ 925

Past Due Loans and Non-performing Assets. The Bank's business processes closely monitor all individual loans, and the relationship officers are charged with working with customers to resolve potential credit issues in a timely manner with a minimum exposure to the organization. The Bank maintains a policy of adding an appropriate amount to the allowance for loan losses to ensure an adequate reserve based on the portfolio composition, specific credit extended by the Bank, experience or historic factors and general economic conditions. On December 31, 2008, past due loans stood at \$683,000 or 0.61% of year-end loans. This compared to past due loans of \$364,000 or 0.34% of total loans outstanding for December 31, 2007. The Bank is pleased with a delinquency ratio that consistently remains below 1%.

Non-performing assets consist of impaired loans, non-accrual loans and real estate owned by the Bank resulting from a foreclosure proceeding. Loans are placed on non-accrual when a loan is specifically determined to be impaired and/or when principal or interest is delinquent in excess of 90 days. On December 31, 2008, non-performing assets stood at \$1.8 million or 1.58% of year-end loans. This compared to the \$1.0 million non-performing balance, or 0.94%, of total loans outstanding for December 31, 2007.

The following table represents an analysis of the non-performing assets and past due loans for the periods indicated:

Non-Performing Assets and Past Due Loans

	December 31,	
	2008	2007
(Dollars in Thousands)		
Non-Performing Assets:		
Impaired Loans	\$ 150	\$ 847
Non-Accruing Loans	\$ 1,613	\$ 156
Total Non-Performing Assets:	\$ 1,763	\$ 1,003
Past Due Loans:		
Commerical	\$ 8	\$ -
Real estate	675	363
Consumer	-	1
Total Past Due Loans	\$ 683	\$ 364
Non-Performing Assets to Total Loans	1.58%	0.94%
Past Due Loans to Total Loans	0.61%	0.34%
Past due and Non-Performing Assets to Total Loans	2.19%	1.28%

Deposits. The Bank seeks deposits within the market area by paying competitive interest rates, offering high quality customer service and using technology to deliver deposit services effectively. As of December 31, 2008, the deposit portfolio grew to \$142.9 million, a 12.08% or a \$15.4 million increase over the December 31, 2007 level of \$127.5 million. Non-interest bearing demand deposits rose by 7.41%, or \$1.8 million, to a December 31, 2008 level of \$26.1 million. Other interest bearing deposits jumped 22.81% or \$6.5 million in response to a new fully electronic paperless NOW product implemented at the beginning of the year and offering a more attractive rate of interest. This category rose to a year-end level of \$35.0 million.

Time deposit growth again rose during 2008 as money flowed out of equity markets to seek the security of insured deposits. The Bank also joined the CDARS network in April of 2008. Through this network, we are able to offer up to \$50 million in FDIC coverage to any larger depositor by dividing funds for larger accounts into smaller fully insurable blocks invested at adequately capitalized community banks across the country. In an amount equal to the funds of the large depositor, the Bank receives numerous reciprocal insurable blocks from clients of other member banks. In addition to these reciprocal arrangements, the Bank may utilize the network for a liquidity management tool by accepting outside deposits during periods of funding needs and investing excess funds during times of excess liquidity as an alternative to overnight funds. These deposits, both reciprocal and non-reciprocal, are classified as brokered deposits for reporting purposes; however, the Bank views reciprocal relationships internally as non-brokered in nature.

Total time deposit instruments increased \$7.1 million over the December 31, 2007 balance of \$74.7 million to \$81.8 million, an increase of 9.50%. Of the total, \$74.5 million is in locally-accepted non-brokered accounts. As of December 31, 2008, the Bank held \$7.3 million in CDARS brokered deposit relationships, \$1.3 million of which was in reciprocal deposit arrangements. The Bank held \$6.0 million in non-reciprocal brokered deposits as of December 31, 2008. As of December 31, 2007, the Bank had no brokered deposits.

The following table details the average amount of, and the average rate paid on, the following primary deposit categories for the periods indicated:

Average Deposit Balances, Interest Expense and Average Rates

	Period Ended December 31,					
	2008			2007		
	Average Balance	Interest Expense	Average Rate	Average Balance	Interest Expense	Average Rate
	(Dollars in Thousands)					
Interest bearing liabilities:						
Interest-bearing demand deposits	\$ 14,988	\$ 190	1.27%	\$ 9,705	\$ 38	0.39%
Money market deposit accounts	7,409	85	1.15%	6,715	127	1.89%
Savings accounts	11,617	69	0.59%	12,902	77	0.60%
Time deposits	77,045	3,139	4.07%	69,289	3,134	4.52%
Total interest-bearing deposits	111,059	<u>\$ 3,483</u>	<u>3.14%</u>	98,611	<u>\$ 3,376</u>	<u>3.42%</u>
Demand deposits	<u>24,793</u>			<u>23,803</u>		
Total deposits	<u>\$ 135,852</u>			<u>\$ 122,414</u>		

A summary of maturity distributions for the total certificates of deposit as of December 31, 2008 is depicted in the following table:

Certificate of Deposit Maturity Distribution

	December 31, 2008			
	Three Months or Less	Three Months to Twelve Months	Over Twelve Months	Total
	(Dollars in Thousands)			
Certificates of Deposit:				
Less than \$100,000 (excluding CDARS)	\$ 10,574	\$ 19,967	\$ 22,769	\$ 53,310
CDARS less than \$100,000	581	2,358	634	3,573
Total less than \$100,000	<u>\$ 11,155</u>	<u>\$ 22,325</u>	<u>\$ 23,403</u>	<u>\$ 56,883</u>
Greater than or equal to \$100,000 (excluding CDARS)	6,023	7,185	7,940	21,148
CDARS greater than or equal to \$100,000	1,919	1,842	-	3,761
Total greater than or equal to \$100,000	<u>\$ 7,942</u>	<u>\$ 9,027</u>	<u>\$ 7,940</u>	<u>\$ 24,909</u>
Total Certificates of Deposit	<u><u>\$ 19,097</u></u>	<u><u>\$ 31,352</u></u>	<u><u>\$ 31,343</u></u>	<u><u>\$ 81,792</u></u>

The following two tables depict summary of maturity distributions for non-brokered and brokered certificates of deposit, respectively, as of December 31, 2008:

Non-Brokered Maturity Distribution of Certificates of Deposits

	December 31, 2008			
	Three Months or Less	Three Months to Twelve Months	Over Twelve Months	Total
	(Dollars in Thousands)			
Non-Brokered Certificates of Deposit:				
Less than \$100,000	\$ 10,574	\$ 19,967	\$ 22,769	\$ 53,310
Greater than or equal to \$100,000	6,023	7,185	7,940	21,148
Total Non-Brokered Certificates of Deposit	<u>\$ 16,597</u>	<u>\$ 27,152</u>	<u>\$ 30,709</u>	<u>\$ 74,458</u>

Brokered Maturity Distribution of Certificates of Deposits

	December 31, 2008			
	Three Months or Less	Three Months to Twelve Months	Over Twelve Months	Total
	(Dollars in Thousands)			
Brokered Certificates of Deposit:				
CDARS less than \$100,000	\$ 581	\$ 2,358	\$ 634	\$ 3,573
CDARS greater than or equal to \$100,000	1,919	1,842	-	3,761
Total Brokered Certificates of Deposit	<u>\$ 2,500</u>	<u>\$ 4,200</u>	<u>\$ 634</u>	<u>\$ 7,334</u>

Liquidity. The overall Asset/Liability strategy of the organization takes into account the need for the Bank to maintain adequate liquidity to fund asset growth and deposit runoff. The management of the Bank monitors the liquidity position daily in conjunction with the Federal Reserve position monitoring. The Bank has credit lines both secured and unsecured available from several correspondent banks. Additionally, the Bank may borrow funds from the FHLB. The credit facilities are used in conjunction with the normal deposit strategies, which include pricing changes to increase deposits as necessary. The organization can sell or pledge investment securities to create additional liquidity for the Bank. From time to time the organization may sell or participate out loans to create additional liquidity as required.

The aggregate amounts of borrowed funds at December 31, 2008 and 2007 are \$3.3 million and \$13.7 million, respectively. At December 31, 2008, the following scheduled debt payments are due:

2009	\$ 333,333
2010	333,333
2011	333,333
2012	333,333
2013	333,333
Thereafter	<u>1,666,668</u>
Total	<u>\$ 3,333,333</u>

Off-Balance Sheet Transactions. The organization enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance sheet transactions. The off-balance sheet transactions recognized as of December 31, 2008 were commitments to extend credit, letters of credit to secure public deposits of the state and local governments of Virginia, and standby letters of credit. The organization does not have any off-balance sheet subsidiaries or special purpose entities.

A summary of the contract amount of the Bank's exposure to off-balance-sheet risk as of December 31, 2008 and 2007 is as follows:

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 11,496,720	\$ 11,105,815
Federal Home Loan Bank letter of credit to secure public deposits	2,750,000	2,750,000
Standby letters of credit	504,038	431,434

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. FHLB letters of credit are used by the Bank to collateralize the uninsured portions of funds of the Commonwealth of Virginia and its local governments. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements.

Capital. The Bank is considered “well capitalized” under the risk-based capital guidelines adopted by the various regulatory agencies. Shareholders’ equity was \$17.4 million on December 31, 2008 and \$18.1 million on December 31, 2007. The Bank’s general policy is to retain the majority of annual earnings to support future organizational growth; however, the Bank has, during the fourth quarter of each year, declared a cash dividend of approximately 35% to 45% of fiscal net earnings. A \$0.27 per common share dividend or 41.54% of earnings was declared in December 2008, matching the cash dividend per share declared in December of 2007. The December 2007 cash dividend represented 40.23% of fiscal 2007 earnings.

The following table shows the Bank’s capital ratios and the minimum capital ratios currently required by bank regulators:

Risk Based Capital Analysis			
December 31,			
	2008	2007	
(Dollars in Thousands)			
Tier 1 Capital:			
Common stock	\$ 3,853	\$ 3,853	
Capital surplus	5,894	5,894	
Retained earnings	7,621	8,321	
Reverse: Unrealized Gains/Losses	1,351	(81)	
Total tier 1 capital	18,719	17,987	
Tier 2 Capital:			
Allowance for loan losses	1,135	925	
Tier 3 Capital:			
Deduction for Investments in Financial Subsidiaries	(180)	(140)	
Total Risk Based Capital	\$ 19,674	\$ 18,772	
Risk weighted assets	\$ 130,354	\$ 115,914	
Quarterly average assets	\$ 165,210	\$ 158,577	
December 31,			Regulatory
	2008	2007	Minimum
Capital Ratios:			
Tier 1 risk based capital ratio	14.36%	15.52%	4.00%
Total risk based capital ratio	15.09%	16.19%	8.00%
Leverage ratio	11.33%	11.34%	4.00%

Return on Average Assets and Average Equity

The ratio of net income to average shareholders' equity and average assets and certain other ratios are as follows:

	December 31,	
	2008	2007
	(Dollars in Thousands)	
Average total assets	\$ 165,750	\$ 155,356
Average shareholders' equity	\$ 18,205	\$ 17,725
Net income	\$ 1,252	\$ 1,293
Cash dividends declared	\$ 520	\$ 520
Return on average assets	0.76%	0.83%
Return on average shareholders' equity	6.88%	7.29%
Average shareholders' equity to average total assets	10.98%	11.41%

Impact of Inflation and Changing Prices and Seasonality

The financial statements and related data presented herein have been prepared in accordance with generally accepted accounting principles which require the measurement of financial position in operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Unlike industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the price of goods and services, since such prices are affected by inflation.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Not applicable to small business filers.

Item 8. Financial Statements and Supplementary Data



Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders
Bank of McKenney
McKenney, VA

We have audited the accompanying consolidated balance sheets of Bank of McKenney and subsidiary as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Bank of McKenney and subsidiary as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with U.S. generally accepted accounting principles.

We were not engaged to examine management's assessment of the effectiveness of Bank of McKenney and subsidiary's internal control over financial reporting as of December 31, 2008 included in the accompanying *Management's Report on Internal Control over Financial Reporting* and, accordingly, we do not express an opinion thereon.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
March 10, 2009

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 2008 and 2007

Assets	2008	2007
Cash and due from banks	\$ 6,847,451	\$ 3,666,898
Federal funds sold	858,000	7,557,000
Interest-bearing time deposits in banks	1,540,252	--
Securities available for sale, at fair market value	28,998,239	28,807,961
Securities held to maturity, fair value of \$956,220	956,448	--
Restricted investments	789,525	1,274,025
Loans, net of allowance for loan losses of \$1,135,000 in 2008 and \$925,000 in 2007	110,648,780	106,102,635
Land, premises and equipment, net	8,185,167	8,361,377
Accrued interest receivable	897,883	752,668
Bank owned life insurance	3,127,712	2,999,852
Other assets	<u>2,612,367</u>	<u>1,669,037</u>
 Total assets	 <u>\$ 165,461,824</u>	 <u>\$ 161,191,453</u>
 Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$ 26,141,215	\$ 24,279,539
Interest-bearing	<u>116,751,608</u>	<u>103,239,533</u>
Total deposits	\$ 142,892,823	\$ 127,519,072
Borrowed funds	3,333,333	13,666,667
Accrued interest payable	324,396	416,040
Accrued expenses and other liabilities	<u>1,543,650</u>	<u>1,520,973</u>
Total liabilities	<u>\$ 148,094,202</u>	<u>\$ 143,122,752</u>
 Commitments and contingencies	 --	 --
 Shareholders' Equity		
Common stock, \$2 par value, authorized 2,250,000 shares; issued and outstanding 1,926,656	\$ 3,853,312	\$ 3,853,312
Surplus	5,893,958	5,893,958
Retained earnings	8,972,226	8,240,118
Accumulated other comprehensive income/(loss)	<u>(1,351,874)</u>	<u>81,313</u>
Total shareholders' equity	<u>\$ 17,367,622</u>	<u>\$ 18,068,701</u>
 Total liabilities and shareholders' equity	 <u>\$ 165,461,824</u>	 <u>\$ 161,191,453</u>

See Notes to Consolidated Financial Statements.

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Statements of Income

For the Three Years Ended December 31, 2008

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Interest and Dividend Income			
Interest and fees on loans	\$ 8,300,465	\$ 8,272,897	\$ 7,755,673
Interest and dividends on securities - taxable	1,402,858	1,147,999	1,110,356
Interest on securities - nontaxable	150,615	82,261	44,998
Interest on deposits in banks	74,187	24,423	59,178
Interest on federal funds sold	96,825	325,800	152,691
Total interest and dividend income	<u>\$ 10,024,950</u>	<u>\$ 9,853,380</u>	<u>\$ 9,122,896</u>
Interest Expense			
Interest on deposits	\$ 3,484,071	\$ 3,376,132	\$ 2,661,855
Interest on federal funds purchased	5,908	--	2,064
Interest on borrowed funds	458,680	653,894	670,172
Total interest expense	<u>\$ 3,948,659</u>	<u>\$ 4,030,026</u>	<u>\$ 3,334,091</u>
Net interest income	\$ 6,076,291	\$ 5,823,354	\$ 5,788,805
Provision for loan losses	358,078	81,819	45,781
Net interest income after provision for loan losses	<u>\$ 5,718,213</u>	<u>\$ 5,741,535</u>	<u>\$ 5,743,024</u>
Noninterest Income			
Service charges on deposit accounts	\$ 849,926	\$ 828,122	\$ 730,761
Secondary market origination fees	435,479	358,101	426,559
Net gain (loss) on sales of available for sale securities	250,016	67,129	(21,375)
Bank-owned life insurance	127,861	121,915	113,742
Other operating income	230,154	188,534	214,168
Gain (loss) on sale of fixed assets	(26,268)	57,276	4,253
Gain (loss) on sale of other real estate owned	(4,387)	2,049	--
Total noninterest income	<u>\$ 1,862,781</u>	<u>\$ 1,623,126</u>	<u>\$ 1,468,108</u>
Noninterest Expense			
Salaries and employee benefits	\$ 3,528,746	\$ 3,391,290	\$ 3,353,810
Occupancy expense	382,265	318,202	312,669
Furniture and equipment expense	483,058	445,238	441,145
Data processing	222,115	212,083	166,162
Telecommunications	142,377	113,588	107,294
Stationery and supplies	96,163	98,540	116,589
Audit and accounting fees	147,230	159,133	150,431
Corporate franchise tax	123,502	114,223	111,167
Other operating expenses	760,405	661,671	614,413
Total noninterest expenses	<u>\$ 5,885,861</u>	<u>\$ 5,513,968</u>	<u>\$ 5,373,680</u>
Income before income taxes	\$ 1,695,133	\$ 1,850,693	\$ 1,837,452
Income tax expense	442,828	557,593	570,585
Net income	<u>\$ 1,252,305</u>	<u>\$ 1,293,100</u>	<u>\$ 1,266,867</u>
Earnings per Share			
Net income, basic and diluted	<u>\$ 0.65</u>	<u>\$ 0.67</u>	<u>\$ 0.66</u>

See Notes to Consolidated Financial Statements.

BANK OF MCKENNEY AND SUBSIDIARY
Consolidated Statements of Changes in Shareholders' Equity
For the Three Years Ended December 31, 2008

	<u>Common Stock</u>	<u>Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Comprehensive Income (Loss)</u>	<u>Total</u>
Balance at December 31, 2005	\$ 3,853,312	\$ 5,893,958	\$ 6,682,012	\$ (646,785)		\$ 15,782,497
Comprehensive income:						
Net income	--	--	1,266,867	--	\$ 1,266,867	1,266,867
Other comprehensive income:						
Unrealized holding gains on securities available for sale arising during the period, net of tax of \$173,012	--	--	--	--	335,845	--
Add reclassification adjustment, net of tax of \$7,267	--	--	--	--	14,108	--
Other comprehensive income, net of tax	--	--	--	349,953	<u>\$ 349,953</u>	349,953
Total comprehensive income					<u>\$ 1,616,820</u>	
Cash dividends declared (\$.25 per share)	--	--	(481,664)	--		(481,664)
Balance at December 31, 2006	<u>\$ 3,853,312</u>	<u>\$ 5,893,958</u>	<u>\$ 7,467,215</u>	<u>\$ (296,832)</u>		<u>\$ 16,917,653</u>
Comprehensive income:						
Net income	--	--	1,293,100	--	\$ 1,293,100	1,293,100
Other comprehensive income:						
Unrealized holding gains on securities available for sale arising during the period, net of tax of \$217,626	--	--	--	--	422,450	--
Less reclassification adjustment, net of tax of (\$22,824)	--	--	--	--	(44,305)	--
Other comprehensive income, net of tax	--	--	--	378,145	<u>\$ 378,145</u>	378,145
Total comprehensive income					<u>\$ 1,671,245</u>	
Cash dividends declared (\$.27 per share)	--	--	(520,197)	--		(520,197)
Balance at December 31, 2007	<u>\$ 3,853,312</u>	<u>\$ 5,893,958</u>	<u>\$ 8,240,118</u>	<u>\$ 81,313</u>		<u>\$ 18,068,701</u>
Comprehensive loss:						
Net income	--	--	1,252,305	--	\$ 1,252,305	1,252,305
Other comprehensive loss:						
Unrealized holding losses on securities available for sale arising during the period, net of tax of (\$653,303)	--	--	--	--	(1,268,176)	--
Less reclassification adjustment, net of tax of (\$85,005)	--	--	--	--	(165,011)	--
Other comprehensive loss, net of tax	--	--	--	(1,433,187)	<u>\$ (1,433,187)</u>	(1,433,187)
Total comprehensive loss					<u>\$ (180,882)</u>	
Cash dividends declared (\$.27 per share)	--	--	(520,197)	--		(520,197)
Balance at December 31, 2008	<u>\$ 3,853,312</u>	<u>\$ 5,893,958</u>	<u>\$ 8,972,226</u>	<u>\$ (1,351,874)</u>		<u>\$ 17,367,622</u>

See Notes to Consolidated Financial Statements.

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Statements of Cash Flows
For the Three Years Ended December 31, 2008

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash Flows from Operating Activities			
Net income	\$ 1,252,305	\$ 1,293,100	\$ 1,266,867
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	501,566	447,752	452,343
Provision for loan losses	358,078	81,819	45,781
Net (gain) loss on sales of securities available for sale	(250,016)	(67,129)	21,375
Net (gain) loss on sale of fixed assets	26,268	(57,276)	(4,253)
Net (gain) loss on sale of other real estate	4,387	(2,049)	--
Net amortization (accretion) of premiums (discounts) on securities	(73,318)	9,844	20,304
Deferred tax (benefit)	(121,302)	(24,868)	(72,920)
Changes in assets and liabilities:			
(Increase) decrease in accrued interest receivable	(145,215)	95,512	(210,191)
(Increase) in other assets	(209,089)	(322,533)	(222,536)
Increase (decrease) in accrued interest payable	(91,644)	80,025	117,801
Increase in accrued expenses and other liabilities	22,677	118,963	115,111
Net cash provided by operating activities	<u>\$ 1,274,697</u>	<u>\$ 1,653,160</u>	<u>\$ 1,529,682</u>
Cash Flows from Investing Activities			
Net change in interest-bearing deposits in banks	\$ (1,540,252)	\$ --	\$ 3,015,123
Activity in available for sale securities:			
Sales	7,227,306	4,008,580	1,974,600
Maturities, prepayments and calls	19,885,150	4,477,026	4,285,520
Purchases	(29,151,862)	(8,757,115)	(8,640,070)
Activity in held to maturity securities:			
Sales	--	--	--
Maturities, prepayments and calls	--	--	--
Purchases	(955,480)	--	--
Sale (purchase) of restricted securities	484,500	11,100	(19,900)
Net increase in loans	(5,238,701)	(5,282,950)	(7,653,296)
Purchases of land, premises and equipment	(351,624)	(2,102,942)	(593,281)
Proceeds from sale of fixed assets	--	238,410	25,000
Proceeds from sale of other real estate	327,599	92,000	--
Net cash used in investing activities	<u>\$ (9,313,364)</u>	<u>\$ (7,315,891)</u>	<u>\$ (7,606,304)</u>

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Statements of Cash Flows

(Continued)

For the Three Years Ended December 31, 2008

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash Flows from Financing Activities			
Net increase (decrease) in demand and savings deposits	\$ 1,861,676	\$ 388,548	\$ (401,207)
Net increase in time deposits	13,512,075	7,868,921	8,999,794
Dividends paid	(520,197)	(481,664)	(423,864)
Payments on FHLB advances and other borrowed funds	<u>(10,333,334)</u>	<u>(333,333)</u>	<u>(347,780)</u>
Net cash provided by financing activities	<u>\$ 4,520,220</u>	<u>\$ 7,442,472</u>	<u>\$ 7,826,943</u>
Net increase (decrease) in cash and cash equivalents	\$ (3,518,447)	\$ 1,779,741	\$ 1,750,321
Cash and Cash Equivalents			
Beginning of year	<u>11,223,898</u>	<u>9,444,157</u>	<u>7,693,836</u>
End of year	<u>\$ 7,705,451</u>	<u>\$ 11,223,898</u>	<u>\$ 9,444,157</u>
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for:			
Interest	<u>\$ 4,040,303</u>	<u>\$ 3,950,001</u>	<u>\$ 3,216,290</u>
Income taxes	<u>\$ 509,300</u>	<u>\$ 628,080</u>	<u>\$ 613,200</u>
Supplemental Disclosures of Noncash Investing and Financing Activities			
Fair value adjustment for securities	<u>\$ (2,171,495)</u>	<u>\$ 572,947</u>	<u>\$ 530,232</u>
Capitalized interest	<u>\$ --</u>	<u>\$ 23,067</u>	<u>\$ --</u>
Transfer between loans and other real estate owned	<u>\$ 357,599</u>	<u>\$ --</u>	<u>\$ --</u>

See Notes to Consolidated Financial Statements.

BANK OF MCKENNEY AND SUBSIDIARY

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies

Organization

Bank of McKenney (the “Bank”) provides depository and lending services for its customers primarily within the counties of Dinwiddie, Chesterfield and Prince George and the cities of Colonial Heights, Hopewell and Petersburg in Virginia. Therefore, its loans and deposits are concentrated primarily with the citizens of this area. The Bank is subject to competition from other financial institutions. The Bank is also subject to the regulations of the Board of Governors of the Federal Reserve System and the State Corporation Commission of Virginia, and it undergoes periodic examinations by these regulatory authorities.

McKenney Group, LLC (the “Subsidiary”) is a wholly owned subsidiary of the Bank formed in December of 2000 to provide networking solutions to Virginia community banks. Since its inception, its focus has evolved into a wider array of financial services. The Subsidiary maintains investments in Bankers Title, LLC, Bankers Insurance, LLC and Community Bankers Securities.

The accounting and reporting policies of the Bank conform to accounting principles generally accepted in the United States of America and predominant practices within the banking industry. The following is a description of the more significant of these policies.

Principles of Consolidation

The consolidated financial statements include the accounts of the Bank’s wholly owned subsidiary, McKenney Group, LLC. All material intercompany balances and transactions have been eliminated in consolidation.

Cash and Cash Equivalents

For purposes of the statements of cash flows, cash and cash equivalents include cash, due from banks and federal funds sold. Generally, federal funds are sold for one-day periods.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings.

Purchased premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are determined to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Loans

The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans. The ability of the Bank’s debtors to honor their contracts is dependent upon the real estate and general economic conditions of the Bank’s market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses. Interest income is accrued on the unpaid principal balance.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in process of collection. Installment loans are typically charged off no later than 180 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or on credit watch. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures.

Land, Premises, and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is charged to expense over the estimated useful lives of the assets, which range from 3 to 20 years for equipment and 18 to 40 years for buildings and improvements, and is computed using the straight-line method for financial reporting purposes and a combination of straight-line and accelerated methods for tax purposes. The costs of major improvements are capitalized, while costs of ordinary maintenance and repairs are charged to expense as incurred.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of foreclosed real estate and deferred tax assets.

Foreclosed Assets

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, management periodically performs valuations and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Income Taxes

Deferred income tax assets and liabilities are determined using the balance sheet method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with the unrecognized tax benefits are classified as additional income taxes in the statement of income.

Earnings and Dividends Per Share

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. The Bank had no potential common stock as of December 31, 2008, 2007 and 2006.

Earnings and dividends per share are computed based on 1,926,656 weighted average shares outstanding during 2008, 2007 and 2006.

Fair Value Measurements

SFAS No. 157, "Fair Value Measurements", specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Bank's market assumptions. The three levels of the fair value hierarchy under SFAS 157 based on these two types of inputs are as follows:

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 - Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 - Valuation is based on model-based techniques using one or more significant inputs or assumptions that are unobservable in the market.

The following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

Recurring basis:

Securities: Where quoted prices are available in an active market, securities are classified within level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy. Currently, all of the Company's securities are considered to be Level 2 securities.

Non-recurring basis:

Loans held for sale: At December 31, 2008, there were no loans held for sale.

Impaired loans: SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, “Accounting by Creditors for Impairment of a Loan”, including impaired loans measured at an observable market price (if available), or at the fair value of the loan’s collateral (if the loan is collateral dependent). Fair value of the loan’s collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

Other Real Estate Owned: Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

Advertising

The Bank follows the policy of charging the costs of advertising to expense as incurred. Total advertising expense incurred for 2008, 2007 and 2006 was \$65,093, \$64,975 and \$71,874, respectively.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year’s method of presentation.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (“FASB”) reached a consensus on Emerging Issues Task Force (“EITF”) Issue 06-4, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements,” (“EITF Issue 06-4”). In March 2007, the FASB reached a consensus on EITF Issue 06-10, “Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements,” (“EITF Issue 06-10”). Both of these standards require a company to recognize an obligation over an employee’s service period based upon the substantive agreement with the employee such as the promise to maintain a life insurance policy or provide a death benefit postretirement. The Bank adopted the provisions of these standards effective January 1, 2008. The adoption of these standards was not material to the consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The FASB has approved a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The Bank adopted SFAS 157 effective January 1, 2008. The adoption of SFAS 157 was not material to the consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007, with early adoption available in certain circumstances. The Bank adopted SFAS 159 effective January 1, 2008. The Bank decided not to report any existing financial assets or liabilities at fair value that are not already reported, thus the adoption of this statement did not have a material impact on the consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), “Business Combinations” (“SFAS 141(R)”). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity’s first year that begins after December 15, 2008. The Bank does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements, at this time.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51” (“SFAS 160”). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity’s first fiscal year that begins after December 15, 2008, with early adoption prohibited. The Bank does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements, at this time.

In November 2007, the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin No. 109, “Written Loan Commitments Recorded at Fair Value Through Earnings” (“SAB 109”). SAB 109 expresses the current view of the staff that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. Publically traded financial institutions like the Bank were expected to apply the views in Question 1 of SAB 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. Implementation of SAB 109 did not have a material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities – an amendment of SFAS No. 133,” (“SFAS No. 161”). SFAS No. 161 requires that an entity provide enhanced disclosures related to derivative and hedging activities. SFAS No. 161 is effective for the Bank on January 1, 2009.

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles,” (“SFAS No. 162”). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles. SFAS No. 162 is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.” Management does not expect the adoption of the provision of SFAS No. 162 to have any impact on the consolidated financial statements.

In September 2008, the FASB issued FSP FAS 133-1 and FASB Interpretation No. 45-4, “Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161,” (“FSP 133-1 and FIN 45-4”). FSP 133-1 and FIN 45-4 require a seller of credit derivatives to disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, financial performance and cash flows. The disclosures required by FSP 133-1 and FIN 45-4 were effective for the Bank on December 31, 2008 and is not expected to have a material impact on the consolidated financial statements.

In October 2008, the FASB issued FSP FAS 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active,” (“FSP 157-3”). FSP 157-3 clarifies the application of SFAS No. 157 in determining the fair value of a financial asset during periods of inactive markets. FSP 157-3 was effective as of September 30, 2008 and did not have material impact on the Bank’s consolidated financial statements.

In December 2008, the FASB issued FSP No. FAS 140-4 and FIN 46(R)-8, “Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities.” FSP No. FAS 140-4 and FIN 46(R)-8 requires enhanced disclosures about transfers of financial assets and interests in variable interest entities. The FSP is effective for interim and annual periods ending after December 15, 2008. Since the FSP requires only additional disclosures concerning transfers of financial assets and interest in variable interest entities, adoption of the FSP will not affect the Bank’s financial condition, results of operations or cash flows.

In January 2009, the FASB reached a consensus on EITF Issue 99-20-1. This FSP amends the impairment guidance in EITF Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,” to achieve more consistent determination of whether an other-than-temporary impairment has occurred. The FSP also retains and emphasizes the objective of an other-than-temporary impairment assessment and the related disclosure requirements in FASB Statement No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” and other related guidance. The FSP is effective for interim and annual reporting periods ending after December 15, 2008 and shall be applied prospectively. The FSP was effective as of December 31, 2008 and did not have a material impact on the consolidated financial statements.

Note 2. Securities

The amortized cost and fair value of securities, with gross unrealized gains and losses at December 31, 2008 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Value</u>
Available for Sale				
Corporate securities	\$ 13,412,221	\$ 69,250	\$ (2,308,294)	\$ 11,173,177
Mortgage-backed securities	1,199,432	26,125	--	1,225,557
Government agencies	12,200,503	195,850	--	12,396,353
Tax-exempt municipals	4,234,377	27,213	(58,438)	4,203,152
Total	<u>\$ 31,046,533</u>	<u>\$ 318,438</u>	<u>\$ (2,366,732)</u>	<u>\$ 28,998,239</u>
Held to maturity				
Corporate securities	<u>\$ 956,448</u>	<u>\$ --</u>	<u>\$ (228)</u>	<u>\$ 956,220</u>

The amortized cost and fair value of securities, with gross unrealized gains and losses at December 31, 2007 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Value</u>
Available for Sale				
Corporate securities	\$ 1,004,127	\$ --	\$ (29,127)	\$ 975,000
Mortgage-backed securities	1,827,579	39	(2,100)	1,825,518
Government agencies	22,152,627	196,797	(73,853)	22,275,571
Tax-exempt municipals	3,700,426	34,075	(2,629)	3,731,872
Total	<u>\$ 28,684,759</u>	<u>\$ 230,911</u>	<u>\$ (107,709)</u>	<u>\$ 28,807,961</u>

The contractual maturities of investment securities classified as available for sale (“AFS”) and held to maturity (“HTM”) at December 31, 2008 are shown below. Expected maturities may differ from contractual maturities because mortgages underlying the mortgage-backed securities may be called or prepaid without any penalties.

	<u>Available for sale</u>		<u>Held to maturity</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Debt securities				
Maturing within one year	\$ 2,000,000	\$ 2,057,600	\$ -	\$ -
Maturing after one year, but within five years	11,665,758	11,433,469	956,448	956,448
Maturing after five years, but within ten years	16,181,343	14,281,613	-	-
Maturing after ten years	1,199,432	1,225,557	-	-
Total	<u>\$ 31,046,533</u>	<u>\$ 28,998,239</u>	<u>\$ 956,448</u>	<u>\$ 956,448</u>

Notes to Consolidated Financial Statements

Due to volatility in the prices of certain debt securities, future investments in non-government issued investment grade debt will likely be categorized as HTM and carried at amortized cost until maturity. The Bank has the ability and intent to hold all purchases to maturity; however, AFS has historically been chosen to provide for maximum liquidity. The Bank has numerous other means of liquidity and foresees no concern over this election during this low point in the economy. As of December 31, 2008, one issue had been so classified at the time of purchase. No issues were so classified as HTM on December 31, 2007.

Proceeds from sales of AFS securities for the years ended December 31, 2008, 2007 and 2006, amounted to \$7,227,306, \$4,008,580 and \$1,974,600, respectively. Gross realized gains (losses) amounted to \$250,016, \$67,129 and (\$21,375), respectively.

There were no securities pledged to secure public deposits or for other purposes required by law at December 31, 2008 or December 31, 2007. The Bank utilizes a Letter of Credit through the Federal Home Loan Bank of Atlanta (the "FHLB") for meeting the collateral requirements of such deposits.

Due to certain banking relationships with the Federal Reserve Bank of Richmond, the FHLB of Atlanta and Community Bankers' Bank, the Bank had invested \$789,525 and \$1,274,025 at December 31, 2008 and 2007, respectively, in restricted investments required by these entities. These investments are carried at cost, which approximates redemption value.

The Bank had securities in its portfolio at December 31, 2008 and 2007 that reflected an unrealized loss in value. These unrealized losses have been evaluated and are considered to be temporary impairments of the value of the issues. A summary of these securities as of December 31, 2008 and 2007 is depicted in the following:

Description	December 31, 2008					
	Total		Less than 12 Months		12 Months or Greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate securities	\$ 7,650,677	\$ (2,308,294)	\$ 7,650,677	\$ (2,308,294)	\$ -	\$ -
Tax exempt municipals	1,864,924	(58,438)	1,456,136	(49,577)	408,788	(8,861)
Unrealized Loss Positions	<u>\$ 9,515,601</u>	<u>\$ (2,366,732)</u>	<u>\$ 9,106,813</u>	<u>\$ (2,357,871)</u>	<u>\$ 408,788</u>	<u>\$ (8,861)</u>

Description	December 31, 2007					
	Total		Less than 12 Months		12 Months or Greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Government agencies	\$ 11,476,141	\$ (73,853)	\$ -	\$ -	\$ 11,476,141	\$ (73,853)
Mortgage-backed	331,578	(2,100)	-	-	331,578	(2,100)
Corporate securities	975,000	(29,127)	-	-	975,000	(29,127)
Tax exempt municipals	701,943	(2,629)	295,743	(894)	406,200	(1,735)
Unrealized Loss Positions	<u>\$ 13,484,662</u>	<u>\$ (107,709)</u>	<u>\$ 295,743</u>	<u>\$ (894)</u>	<u>\$ 13,188,919</u>	<u>\$ (106,815)</u>

Management evaluates securities for other-than-temporary impairments at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

At December 31, 2008, the securities identified above with unrealized losses consisted of seven corporate issues, and eight issues of different municipalities. The corporate credits are all investment grade placements within the financial services industry which have been significantly affected by the freezing of the credit markets during the period. This market condition, resulting from concerns over the effects the housing bubble collapse is having on the creditworthiness in loan and investment portfolios of financials, has resulted in demand for such debt to fall significantly, leading to violent swings in market prices. In response, the federal government established the Troubled Asset Relief Program (“TARP”) to support financial institutions, and all of the current holdings are eligible for participation in this program or have received other direct government support. With the corporate issuances being investment grade, eligible for government assistance and unrealized losses precipitated by a market circumstance rather than individual debt worthiness, these unrealized losses are currently believed temporary with no permanent impairment expected. All municipal bonds’ unrealized losses reflect changes in the prevailing interest rate environments as well as the issues’ maturities. No principal is expected to be lost, and the unrealized losses, primarily due to interest rates, are considered temporary in nature.

In analyzing an issuer’s financial condition, management considers whether the federal government or its agencies issued the securities, whether downgrades by bond rating agencies have occurred, and industry analysts’ reports. As management has the ability and intent to hold debt securities until maturity, or for the foreseeable future if classified as available for sale, no declines are deemed to be other than temporary.

Note 3. Loans

The composition of loans at December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
Commercial	\$ 7,922,920	\$ 7,607,912
Real estate	91,671,717	84,520,307
Real estate-construction	9,833,256	12,287,133
Installment	1,942,940	2,141,604
Credit cards	412,947	470,679
Total loans	<u>\$ 111,783,780</u>	<u>\$ 107,027,635</u>
Less: Allowance for loan losses	<u>1,135,000</u>	<u>925,000</u>
Loans, net	<u>\$ 110,648,780</u>	<u>\$ 106,102,635</u>

Note 4. Allowance for Loan Losses

Activity in the allowance for loan losses for the years ended December 31, 2008, 2007 and 2006 is as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Balance, beginning	\$ 925,000	\$ 1,070,000	\$ 1,025,000
Loans charged off	(184,398)	(259,434)	(18,213)
Recoveries	36,320	32,615	17,432
Provision	<u>358,078</u>	<u>81,819</u>	<u>45,781</u>
Balance, ending	<u>\$ 1,135,000</u>	<u>\$ 925,000</u>	<u>\$ 1,070,000</u>

The following is a summary of information pertaining to impaired loans at December 31, 2008, 2007 and 2006:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Impaired loans with a valuation allowance	\$ 1,570,055	\$ 1,003,215	\$ 1,561,311
Impaired loans without a valuation allowance	193,028	--	--
Total impaired loans	<u>\$ 1,763,083</u>	<u>\$ 1,003,215</u>	<u>\$ 1,561,311</u>
Valuation allowance related to impaired loans	<u>\$ 409,500</u>	<u>\$ 245,500</u>	<u>\$ 436,000</u>
Average investment in impaired loans	<u>\$ 1,448,309</u>	<u>\$ 1,194,983</u>	<u>\$ 1,656,537</u>
Interest income recognized	<u>\$ 108,988</u>	<u>\$ 128,619</u>	<u>\$ 125,675</u>

There were no non-accrual loans excluded from impaired loan disclosure under SFAS No. 114 at December 31, 2008, 2007 and 2006. There were no loans past due in excess of ninety days and still accruing as of December 31, 2008. Loans still accruing and delinquent in excess of ninety days as of December 31, 2007 and 2006 amounted to \$303,095 and \$687,694, respectively.

Note 5. Land, Premises and Equipment

Land, premises, and equipment at December 31, 2008 and 2007 are composed of the following:

	2008	2007
Land	\$ 1,580,894	\$ 1,607,162
Bank building and improvements	7,228,442	7,059,813
Furniture and equipment	2,449,450	2,268,549
Automobiles	410,900	408,806
Total land, premises and equipment	\$ 11,669,686	\$ 11,344,330
Less accumulated depreciation	3,484,519	2,982,953
Net land, premises and equipment	\$ 8,185,167	\$ 8,361,377

Depreciation expense for the years ended December 31, 2008, 2007 and 2006 amounted to \$501,566, \$447,752 and \$452,343, respectively.

Note 6. Deposits

The aggregate amounts of time deposits in denominations of \$100,000 or more at December 31, 2008 and 2007 are \$24,908,677 and \$21,857,002, respectively.

At December 31, 2008, the scheduled maturities of time deposits are as follows:

2009	\$	50,449,086
2010		21,087,825
2011		5,759,079
2012		1,781,331
2013		2,613,469
Thereafter		101,543
Total	\$	81,792,333

The aggregate amounts of deposit overdrafts reclassified as loans at December 31, 2008 and 2007 are \$13,848 and \$27,406, respectively.

Note 7. Borrowings

The Bank has a FHLB fifteen-year amortizing note with an original balance of \$5,000,000 and interest paid monthly at a fixed rate of 4.79%. The Bank also had a FHLB ten-year non-amortizing note in the amount of \$10,000,000 and interest paid monthly at a fixed rate of 4.70% at the beginning of the current year. During the year, the Bank repaid this ten-year note prematurely with liquidity generated from deposit growth. The current aggregated balance of FHLB note(s) as of December 31, 2008 and 2007 was \$3,333,333 and \$13,666,667 respectively. This remaining loan is secured by a blanket agreement that includes all qualifying 1-4 family residential mortgage loans. As of December 31, 2008, the Bank held \$29,147,079 in qualifying mortgages.

At December 31, 2008, the Bank had \$32,476,976 available under open lines of credit with other financial institutions and the FHLB.

The contractual maturities of borrowings for the year ended December 31, 2008 are as follows:

2009	\$	333,333
2010		333,333
2011		333,333
2012		333,333
2013		333,333
Thereafter		<u>1,666,668</u>
Total	\$	<u>3,333,333</u>

Note 8. Income Taxes

The Bank files income tax returns in the U.S. federal jurisdiction and the state of Virginia. With few exceptions, the Bank is no longer subject to U.S. federal and state income tax examinations by tax authorities for years prior to 2005.

The Bank adopted the provisions of FIN 48, "Accounting for Uncertainty in Income Taxes", on January 1, 2007 with no impact on the financial statements.

Income tax expense for the years ended December 31, 2008, 2007 and 2006 consists of the following:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Current tax expense	\$ 564,130	\$ 582,461	\$ 643,505
Deferred tax (benefit)	<u>(121,302)</u>	<u>(24,868)</u>	<u>(72,920)</u>
Total	<u>\$ 442,828</u>	<u>\$ 557,593</u>	<u>\$ 570,585</u>

Notes to Consolidated Financial Statements

Income tax expense differs from the amounts computed by applying the U. S. Federal income tax rate of 34% in 2008, 2007 and 2006 to earnings before income taxes as a result of the following:

	2008	2007	2006
Computed "expected" tax expense	\$ 576,357	\$ 629,236	\$ 624,734
Tax-exempt interest	(44,563)	(24,013)	(13,331)
Bank-owned life insurance	(43,473)	(41,451)	(38,672)
Qualifying donation of land	(42,069)	--	--
Other, net	(3,424)	(6,179)	(2,146)
Total	\$ 442,828	\$ 557,593	\$ 570,585

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2008 and 2007 are presented below:

	2008	2007
Deferred Tax Assets		
Net unrealized loss on securities available for sale	\$ 696,419	\$ --
Allowance for loan losses	356,771	288,244
Deferred compensation plans	296,631	269,150
Nonaccrual loan interest	32,491	5,561
Deferred tax assets	\$ 1,382,312	\$ 562,955
Deferred Tax Liabilities		
Net unrealized gain on securities available for sale	\$ --	\$ 41,889
Depreciation	107,556	105,920
Deferred tax liabilities	\$ 107,556	\$ 147,809
Net deferred tax assets	\$ 1,274,756	\$ 415,146

Note 9. Employee Benefit Plan

The Bank has a 401(k) defined contribution plan available to substantially all employees. To be eligible for the plan, employees must have been employed for twelve months prior to an entry date into the plan, which is defined as the first day of each plan year and the first day of the seventh month of each plan year. An employee must be at least twenty years of age to be eligible under the plan.

Under this plan, the Bank is required to match participating employees' contributions up to specified limits. The Bank may also, at its discretion, make additional contributions to the plan out of net profits in an amount determined by the Board of Directors. During 2008, 2007 and 2006, 401(k) plan contributions totaled \$145,949, \$146,345 and \$159,632, respectively.

Note 10. Executive Supplemental Income Plans

A Deferred Compensation Income Agreement has been adopted for a key employee, which provides that benefits are to be paid in monthly installments for 10 years following retirement or death. The employee has met the required service period specified under the agreement and will be entitled to the payments at age 65. Salary Continuation Agreements have also been adopted on the key employee, providing benefits to be paid in monthly installments for 15 years following retirement or death. Under the agreements, the employee will be entitled to full benefits at age 65 provided service to the Bank occurs until age 55.

In August 2004, the key employee assigned to the Bank the benefits under a split-dollar life insurance agreement held with the Bank and in exchange therefore entered into a supplemental retirement plan agreement with the Bank. Pursuant to the terms of the agreement, the Bank is granting the key employee a supplemental retirement income benefit equal to \$1,500 monthly for 10 years. Eligibility to start receiving the benefit begins upon reaching the age of 65 or at which time the key employee retires from the Bank in accordance with the Bank's retirement policies. Under the agreement, the key employee becomes 100% vested in the retirement benefit upon the earlier of the age of 62, death or disability, involuntary termination of employment without cause or upon a change in control of the Bank. If the key employee terminates employment with the Bank before the age of 62 for any reason other than as set forth in the preceding sentence, this entire retirement benefit is forfeited.

The executive supplemental income benefit expense for 2008, 2007 and 2006 based on the present value of the retirement benefits amounted to \$84,825, \$101,428 and \$84,005, respectively. The plans are unfunded. However, life insurance has been acquired on the life of this key employee in amounts sufficient to discharge the obligations of the agreement.

Note 11. Related Party Transactions

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with directors, principal officers and affiliated companies in which they are principal shareholders (commonly referred to as related parties) on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. These persons and firms were indebted to the Bank for loans totaling \$1,107,877 and \$1,034,779 at December 31, 2008 and 2007, respectively. During 2008, total principal additions were \$464,868 and total principal payments were \$391,770. Total deposit relationships for related party persons and firms of \$2,548,880 were reported as of December 31, 2008.

Note 12. Fund Restrictions and Reserve Balance

Federal and state regulations limit the amount of dividends the Bank can pay without obtaining prior approval and, additionally, federal regulations require that the Bank maintain a ratio of total capital to assets, as defined by regulatory authorities. As of December 31, 2008, the Bank could declare dividends of \$2,290,214 without prior approval.

As a member of the Federal Reserve System, the Bank must maintain certain average reserve balances. For the final weekly reporting period in the years ended December 31, 2008 and 2007, the aggregate amounts of daily average required balances were approximately \$660,000 and \$649,000, respectively.

Note 13. Capital Requirements

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2008 and 2007, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Bank's actual capital amounts and ratios are also presented in the table.

	<u>Actual</u>		<u>Minimum Capital Requirement</u>		<u>Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
(Amount in Thousands)						
As of December 31, 2008:						
Total Capital (to Risk Weighted Assets)	\$19,674	15.1%	\$10,428	8.0%	\$13,035	10.0%
Tier 1 Capital (to Risk Weighted Assets)	\$18,719	14.4%	\$ 5,214	4.0%	\$ 7,821	6.0%
Tier 1 Capital (to Average Assets)	\$18,719	11.3%	\$ 6,608	4.0%	\$ 8,261	5.0%
As of December 31, 2007:						
Total Capital (to Risk Weighted Assets)	\$18,772	16.2%	\$ 9,273	8.0%	\$11,591	10.0%
Tier 1 Capital (to Risk Weighted Assets)	\$17,987	15.5%	\$ 4,637	4.0%	\$ 6,955	6.0%
Tier 1 Capital (to Average Assets)	\$17,987	11.3%	\$ 6,343	4.0%	\$ 7,929	5.0%

Note 14. Commitments and Contingencies

In the normal course of business, there are outstanding various commitments and contingent liabilities which are not reflected in the accompanying financial statements. The Bank does not anticipate any material losses as a result of these transactions. See Note 15 with respect to financial instruments with off-balance-sheet risk.

Note 15. Financial Instruments With Off-Balance-Sheet Risk

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

A summary of the contract amount of the Bank's exposure to off-balance-sheet risk as of December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 11,496,720	\$ 11,105,815
Federal Home Loan Bank letter of credit to secure public deposits	2,750,000	2,750,000
Standby letters of credit	504,038	431,434

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

The Treasurer of the Commonwealth of Virginia permits FHLB letters of credit as instruments to collateralize the uninsured portions of public funds. The Bank utilizes this methodology to secure public deposits and currently has released all other securities from pledged obligations.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

Note 16. Concentration Risk

The Bank maintains its cash accounts in several correspondent banks. As of December 31, 2008, all correspondents were participating members in the Transaction Guarantee Program instituted by the FDIC on December 14, 2008. This program effectively insures the full balance of non-interest bearing transaction accounts and interest bearing transaction accounts earning a rate of return not greater than 1/2% throughout 2009. Because of this temporary legislation, no deposits were in excess of amounts insured by the Federal Deposit Insurance Corporation.

Note 17. Fair Value Measurements

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Bank's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Therefore, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Bank.

The following methods and assumptions were used by the Bank to estimate fair value disclosures for financial instruments:

Cash and cash equivalents: The carrying amounts of cash and short-term instruments approximate fair values.

Interest-bearing deposits in banks: The carrying amounts of interest-bearing deposits maturing within 90 days approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar deposit types.

Securities: Fair values for securities, excluding restricted investments, are based on quoted market prices. The carrying value of restricted investments approximates fair value based on the redemption provisions of the restricted investments.

Loans receivable: For variable-rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (e.g., one-to-four family residential), credit card loans, and other consumer loans are based on quoted market prices of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics. Fair values for other loans (e.g., commercial real estate and investment property mortgage loans, commercial and industrial loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for non-performing loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Deposit liabilities: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings: The fair values of the Bank's long-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest: The carrying amounts of accrued interest approximate fair values.

Off-balance-sheet instruments: The fair value of commitments to extend credit is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present credit worthiness 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 standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2008 and 2007, fair values of loan commitments and standby letters of credit were immaterial; therefore, they have not been included in the table below.

The estimated fair values, and related carrying or notional amounts, of the Bank's financial instruments are as follows:

	December 31, 2008		December 31, 2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)			
Financial assets:				
Cash and cash equivalents	\$ 7,705	\$ 7,705	\$ 11,224	\$ 11,224
Interest bearing deposits in banks	1,540	1,540	-	-
Securities available-for-sale	28,998	28,998	28,808	28,808
Securities held-to-maturity	956	956	-	-
Restricted investments	790	790	1,274	1,274
Loans, net	110,649	119,119	106,102	107,254
Accrued interest receivable	898	898	753	753
Financial liabilities:				
Deposits	\$ 142,893	\$ 143,641	\$ 127,519	\$ 127,829
Borrowings	3,333	3,340	13,667	11,665
Accrued interest payable	324	324	416	416

Notes to Consolidated Financial Statements

The following describes the valuation techniques used by the Bank to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2).

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008:

<u>Description</u>	<u>Balance as of December 31, 2008</u>	<u>Fair Value Measurements at December 31, 2008 Using</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Assets:				
Available-for-sale securities	\$ 28,998,239	\$ -	\$ 28,998,239	\$ -

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Bank to measure certain financial assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans held for sale: Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Bank records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the year ended December 31, 2008. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the 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 outside of the Bank 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 real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

The following table summarizes the Bank's financial assets that were measured at fair value on a nonrecurring basis during the period.

Description	Carrying value at December 31, 2008			
	Balance as of December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired Loans	\$ 1,160,555	\$ -	\$ 435,052	\$ 725,503

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Bank's financial instruments will change when interest rate levels change, and that change may be either favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

The Bank's management, including its Chief Executive Officer and Chief Financial Officer, evaluated the Bank's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of December 31, 2008. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Bank's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Bank in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Bank's internal controls over financial reporting that occurred during the year ended December 31, 2008 that have materially affected or are reasonably likely to materially affect the Bank's internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Management of the Bank is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Management regularly monitors its internal control over financial reporting and takes appropriate action to correct any deficiencies that may be identified.

Management assessed the Bank's internal control over financial reporting as of December 31, 2008. This assessment was based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concluded that the Bank maintained effective internal control over financial reporting as of December 31, 2008.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, because of changes in conditions, internal control effectiveness may vary over time.

This annual report does not include an attestation report of the Bank's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Bank's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Bank to provide only management's report in this annual report.

/s/ Richard M. Liles
Richard M. Liles
President & Chief Executive Officer

/s/ James B. Neville, Jr.
James B. Neville, Jr.
Executive Vice President & Chief Financial Officer

Dated: March 10, 2009

Item 9B. Other Information

None

Item 10. Directors, Executive Officers and Corporate Governance

All required information on the executive officers and directors of the Bank is incorporated herein by reference from the Bank’s 2009 definitive proxy statement for the annual meeting of shareholders (“Definitive Proxy Statement”), and such proxy statement is expected to be filed with the Federal Reserve within 120 days after the end of the fiscal year to which this report relates.

The following is information on the only two executive officers of the Bank who are not directors of the Bank:

<u>Name (Age)</u>	<u>Principal Occupation Over Last Five Years</u>
James B. Neville, Jr. (45)	Executive Vice President & Chief Financial Officer
Lynda P. Cunningham (47)	Senior Vice President & Chief Operations Officer

Item 11. Executive Compensation

This information is incorporated herein by reference from the Bank’s Definitive Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

This information is incorporated herein by reference from the Bank’s Definitive Proxy Statement.

Item 13. Certain Relationships and Related Transactions, and Director Independence

This information is incorporated herein by reference from the Bank’s Definitive Proxy Statement.

Item 14. Principal Accounting Fees and Services

This information is incorporated herein by reference from the Bank’s Definitive Proxy Statement.

Item 15. Exhibits

The following exhibits are filed as part of this Form 10-K and this list includes the Exhibit Index:

<u>Exhibit Number</u>	<u>Description</u>	<u>Page</u>
3.1	Articles of Incorporation of Bank of McKenney	*
3.2	Amended and Restated Bylaws of Bank of McKenney	**
10.1	Employment Agreement, dated December 8, 1992, by and between Bank of McKenney and Richard M. Liles	*
10.2	Split-Dollar Life Insurance Agreement (as amended), dated February 1, 1989, by and between Bank of McKenney and Richard M. Liles	*
10.3	Deferred Compensation Agreement, dated February 1, 1989, between Bank of McKenney and Richard M. Liles	*
10.4	Deferred Compensation Agreement, dated February 1, 1993, between Bank of McKenney and Richard M. Liles	*
10.5	Form of Change in Control Employment Agreement, as amended, between Bank of McKenney and each of the following officers: James B. Neville, Jr., Lynda P. Cunningham, Mark H. Stevens.	†
10.6	Form of Change in Control Employment Agreement between Bank of McKenney and Michelle S. Fitch	†
21.1	Subsidiary - McKenney Group, LLC (a Virginia corporation)	*
31.1	CEO Section 302 Certification	†
31.2	CFO Section 302 Certification	†
32	Section 906 Certification	†

* Incorporated herein by reference from the Bank's Registration Statement on Form 10-SB, filed with the Board of Governors of the Federal Reserve System on September 9, 2002.

** Incorporated herein by reference from the Bank's report on Form 8-K filed with the Board of Governors of the Federal Reserve System on August 15, 2007.

† Filed herewith.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

BANK OF MCKENNEY

Date: March 10, 2009

By: /s/ Richard M. Liles
Richard M. Liles
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Capacity</u>	<u>Date</u>
<u>/s/ Richard M. Liles</u> Richard M. Liles	President and Chief Executive Officer (principal executive officer)	March 10, 2009
<u>/s/ James B. Neville, Jr.</u> James B. Neville, Jr.	Executive Vice President and Chief Financial Officer (principal financial officer)	March 10, 2009
<u>/s/ W. D. Allen III</u> W.D. Allen III	Director	March 10, 2009
<u>/s/ Harry D. Baird III</u> Harry D. Baird III	Director	March 10, 2009
<u>/s/ Louis J. Blaha, Jr.</u> Louis J. Blaha, Jr.	Director	March 10, 2009
<u>/s/ Joan D. Clarke</u> Joan D. Clarke	Director	March 10, 2009
<u>/s/ L. M. Harrison, Jr.</u> L.M. Harrison, Jr.	Director	March 10, 2009
<u>/s/ Rudy L. Hawkins</u> Rudy L. Hawkins	Director	March 10, 2009
<u>/s/ Joseph W. Lyle</u> Joseph W. Lyle	Director	March 10, 2009
<u>/s/ Edward B. Titmus</u> Edward B. Titmus	Director	March 10, 2009

Exhibit 10.5

AMENDMENTS TO EXISTING CHANGE IN TERMS OF CONTROL AGREEMENTS

Amendments to existing Change in Terms of Control Agreements entered into between Bank of McKenney and certain of its senior officers, James B. Neville, Jr., Lynda P. Cunningham, and Mark H. Stevens (Incorporated by reference from the Bank's Annual Report on Form 10-KSB for the year ended December 31, 2004, filed with the Board of Governors of the Federal Reserve System on March 8, 2005) are being filed with the Board of Governors of the Federal Reserve System as Exhibit 10.5 to Bank of McKenney's Annual Report on Form 10-K for the year ended December 31, 2008.

CHANGE IN TERMS OF CONTROL AGREEMENTS

A Change in Terms of Control Agreements entered into between Bank of McKenney and Michelle S Fitch on January 28, 2009 is being filed with the Board of Governors of the Federal Reserve System as Exhibit 10.6 to Bank of McKenney's Annual Report on Form 10-K for the year ended December 31, 2008.

CERTIFICATIONS

I, Richard M. Liles, certify that:

1. I have reviewed this annual report on Form 10-K of Bank of McKenney;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Richard M. Liles
Richard M. Liles
President and Chief Executive Officer

Date: March 10, 2009

CERTIFICATIONS

I, James B. Neville, Jr., certify that:

1. I have reviewed this annual report on Form 10-K of Bank of McKenney;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ James B. Neville, Jr.
James B. Neville, Jr.
Executive Vice President and Chief Financial Officer

Date: March 10, 2009

***CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350 AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002***

In connection with the Annual Report of Bank of McKenney (the “Bank”) on Form 10-K for the period ending December 31, 2008 as filed with the Board of Governors of the Federal Reserve System on the date hereof (the “Report”), the undersigned Chief Executive Officer and Chief Financial officer of the Bank hereby certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 that based on their knowledge and belief: 1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and 2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Bank as of and for the periods covered in the Report.

/s/ Richard M. Liles

Richard M. Liles

President and Chief Executive Officer

/s/ James B. Neville, Jr.

James B. Neville, Jr.

Executive Vice President and Chief Financial Officer

Dated: March 10, 2009