

**Board of Governors of the Federal Reserve System
Washington, D.C. 20551**

Form 10-KSB

**ANNUAL REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

BANK OF MCKENNEY

(Name of small business issuer 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 23872
(Address of principal executive offices) (Zip Code)

Issuer's telephone number: (804) 478-4434

Securities registered pursuant to Section 12(b) of the Act: None

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

Common Stock, \$2.00 par value
(Title of Class)

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. []

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or 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 [X] No []

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will 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-KSB or any amendment to this Form 10-KSB. [X]

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

Issuer's revenue for the fiscal year ended December 31, 2005: \$ 9,311,000.

The aggregate market value of Bank of McKenney voting stock held by non-affiliates as of March 13, 2006 was \$19,981,848. This figure is based on the closing price of \$11.44 per share of the Registrant's common stock on March 13, 2006.

The number of shares of common stock outstanding as of March 13, 2006 was 1,926,656.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement to be used in conjunction with the registrant's 2006 Annual Meeting of Shareholders are incorporated into Part III of this Form 10-KSB.

Transitional Small Business Disclosure Format: Yes [] No [X]

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This Form 10-KSB 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-KSB 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.

PART I.

Item 1. Description of 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 and Chesterfield counties and the City of Colonial Heights. 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 \$142 million at December 31, 2005, and our shareholders’ equity has grown from approximately \$700,000 in 1989 to \$15.8 million at 2005 year’s end. Furthermore, we have paid an annual dividend for at least the last 40 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 61 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, Chesterfield County and the City of Colonial Heights, 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 the 2000 census, the population of Dinwiddie County was 24,553, a 10.1% increase from 1990 to 2000. The average household income in Dinwiddie County in 2000 was \$34,830, representing an increase of 18.5% from 1990. The population of the City of Colonial Heights was 16,897 in 2000, a 5.2% increase from 1990 to 2000. Average household income grew to \$40,923 in 2000, representing an increase of 18.7% over the same time period. Chesterfield County continues to experience robust growth. The population in Chesterfield has increased 24.0% from 1990 to 2000, and the average household income has grown to \$55,324 in 2000, representing a 28.3% increase from 1990.

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, Chesterfield County and the City of Colonial Heights. 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 its 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 the 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 written loan policy and related procedures to enhance management of credit risk. 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 loan policy is to establish 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 loan procedures, outline basic credit criteria, 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 \$150,000 for either secured or unsecured loans. An Officer's Loan Committee comprised of all officers of the Bank and requiring positive action by three or more members can approve credits of up to \$500,000. The Director's Loan Committee, consisting of the entire board of directors, meeting monthly, can approve loans over \$500,000, requiring at least three members to be present in order to act. The Bank's legal lending limit for loans to one borrower was \$2,367,000 as of December 31, 2005.

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 is generally classified as "Available For Sale." Under such a classification, investment instruments may be sold as deemed appropriate by management. On a monthly basis, 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.

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.

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, Chesterfield County, the City of Colonial Heights and adjacent areas.

Supervision and Regulation

General

We are organized as a Virginia-chartered banking corporation 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, issuance 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 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 Federal Deposit Insurance Corporation have adopted capital adequacy requirements, which apply to us.

FDIC Deposit Insurance

Our customers' deposits are insured by the Bank Insurance Fund ("BIF") of the Federal Deposit Insurance Corporation; thusly, we are subject to insurance assessments imposed by the Federal Deposit Insurance Corporation. Currently, a risk-based assessment schedule imposes assessments on BIF deposits ranging from zero to 0.27% of a bank's average assessment base. The actual assessment paid is based on the institution's assessment risk classification, which is determined based on whether the institution is considered "well capitalized," "adequately capitalized" or "undercapitalized," as such terms have been defined in applicable federal regulations, and whether such institution is considered by its supervisory agency to be financially sound or to have supervisory concerns. In February 2006, Congress enacted the Federal Deposit Insurance Reform Act of 2005 (the "FDIR Act"). As a result of the passage of the FDIR Act, over the course of the next year, among other things: (i) the BIF will be merged with the FDIC's Savings Association Insurance Fund creating the Deposit Insurance Fund (the "DIF"); (ii) the \$100,000 per account insurance level will be indexed to reflect inflation; (iii) deposit insurance coverage for certain retirement accounts will be increased to \$250,000; and (iv) a cap will be placed on the level of the DIF and dividends will be paid to banks once the level of the DIF exceeds the specified threshold.

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, 2005, 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 | 15.99% | 4.00% |
| Total risk-based capital | 16.79% | 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 Federal Deposit Insurance Corporation. 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 Federal Deposit Insurance Corporation 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 2002.

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 instant 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 provides 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 new 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, because of our relatively recent organization, 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 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.

This legislation likely will affect bank capital spending as many financial institutions assess whether technological or operational changes are necessary to stay competitive and take advantage of the new opportunities presented by Check 21.

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 thereunder, which are aimed at improving corporate governance and reporting procedures. The Bank is complying with the new 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 will also be 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 will be 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 2. Description of Property

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 Ettrick Branch, located in southern Chesterfield near the cities of Colonial Heights and Petersburg;
- the McKenney Branch, located in southern Dinwiddie County in the Town of McKenney;
- the Colonial Heights Branch, located in the city of Colonial Heights.

All of our facilities and branch locations are owned, and the Bank does not lease any properties. In November 2005, the Bank acquired for expansion of its trade area 3.3 acres in central Prince George County at the intersection of Courthouse Road and Prince George Drive. Also, the Bank signed a contract on an additional 1.5 acres on Jefferson Park Road in western Prince George near the County's border with the City of Hopewell. Closing on this parcel is slated for January 2006. These two strategic locations resulted from a year-long demographic study by the Board and management, the criteria being (1) natural and logical progression of the existing trade area; (2) area(s) demonstrating existing and projected growth; (3) selections having room for additional competition as opposed to those seemingly over-banked; and (4) opportunities in localities more receptive to the personalized style of service offered by community bank. The Bank also owns three 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 Common Equity and Related Stockholder Matters

The Bank's common stock began trading on the Nasdaq SmallCap Market (now the Nasdaq Capital Market) under the symbol "BOMK" on September 26, 2002. There were 1,926,656 shares of the Bank's stock issued and outstanding at the close of business on December 31, 2005, which were held by approximately 453 shareholders of record. The closing price of the Bank's stock on December 31, 2005 was \$10.48 per share as compared to \$9.80 on December 31, 2004.

The following table summarizes the high and low sales prices and dividends declared for the two years ended December 31, 2005.

| | Market Values | | | | Dividends Declared | |
|----------------|---------------|---------|---------|---------|--------------------|------|
| | 2005 | | 2004 | | 2005 | 2004 |
| | High | Low | High | Low | | |
| First Quarter | \$10.75 | \$ 9.80 | \$13.50 | \$12.50 | \$ - | \$ - |
| Second Quarter | 10.40 | 9.80 | 12.95 | 9.95 | - | - |
| Third Quarter | 11.00 | 9.90 | 10.50 | 9.05 | - | - |
| Fourth Quarter | 10.55 | 9.75 | 10.95 | 9.10 | 0.22 | 0.20 |

Item 6. Management's Discussion and Analysis or Plan of Operation

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

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 special mention. 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 customer 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.

Selected Summary Financial Data

| | Period Ended December 31, | | | | |
|---|--|------------|------------|------------|-----------|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| | (Dollars in Thousands, except per share and share information) | | | | |
| Income Statement Data: | | | | | |
| Interest income | \$ 7,882 | \$ 7,085 | \$ 6,606 | \$ 6,504 | \$ 6,165 |
| Interest expense | 2,294 | 1,742 | 1,618 | 2,112 | 2,504 |
| Net interest income | 5,588 | 5,343 | 4,988 | 4,392 | 3,661 |
| Provision for loan losses | 41 | 102 | 126 | 172 | 130 |
| Non-interest income | 1,429 | 1,429 | 1,568 | 1,359 | 1,291 |
| Non-interest expense | 5,047 | 4,844 | 4,497 | 3,938 | 3,427 |
| Income taxes | 606 | 577 | 633 | 525 | 445 |
| Net income | \$ 1,323 | \$ 1,249 | \$ 1,300 | \$ 1,116 | \$ 950 |
| Per Share and Shares Outstanding Data: | | | | | |
| Basic net income | \$ 0.69 | \$ 0.65 | \$ 0.67 | \$ 0.74 | \$ 0.70 |
| Fully diluted net income | 0.69 | 0.65 | 0.67 | 0.74 | 0.70 |
| Cash dividends declared | 0.22 | 0.20 | 0.17 | 0.15 | 0.13 |
| Book value at period end | 8.19 | 7.97 | 7.56 | 7.14 | 5.77 |
| Shares outstanding, period end | 1,926,656 | 1,926,656 | 1,926,656 | 1,926,656 | 1,351,656 |
| Average shares outstanding, basic | 1,926,656 | 1,926,656 | 1,926,656 | 1,504,464 | 1,351,656 |
| Average shares outstanding, diluted | 1,926,656 | 1,926,656 | 1,926,656 | 1,504,464 | 1,351,656 |
| Balance Sheet Data: | | | | | |
| Total assets | \$ 142,202 | \$ 132,271 | \$ 124,317 | \$ 105,262 | \$ 85,126 |
| Total loans, net | 93,294 | 92,708 | 85,304 | 72,345 | 62,566 |
| Total investment securities | 26,303 | 21,240 | 18,123 | 12,873 | 8,562 |
| Total interest-bearing time deposits in other banks | 3,015 | -- | -- | 200 | 300 |
| Total deposits | 110,663 | 111,070 | 103,757 | 90,366 | 75,848 |
| Total borrowed funds | 14,348 | 4,702 | 5,057 | 276 | 695 |
| Shareholders' equity | 15,782 | 15,364 | 14,560 | 13,747 | 7,793 |
| Performance Ratios: | | | | | |
| Return on average assets | 0.95% | 0.97% | 1.16% | 1.19% | 1.21% |
| Return on average equity | 8.35% | 8.24% | 9.04% | 11.47% | 12.57% |
| Net interest margin ⁽¹⁾ | 4.54% | 4.69% | 5.02% | 5.31% | 5.26% |
| Asset Quality Ratios: ⁽²⁾ | | | | | |
| Allowance to period-end loans | 1.09% | 1.07% | 1.04% | 1.09% | 1.03% |
| Nonperforming assets to total loans | 1.86% | 1.71% | 0.08% | 0.10% | 0.11% |
| Capital Ratios: | | | | | |
| Tier 1 risk-based capital | 15.99% | 15.35% | 16.01% | 17.96% | 12.43% |
| Total risk-based capital | 16.79% | 16.14% | 16.79% | 18.77% | 13.47% |
| Leverage capital ratio | 11.33% | 11.70% | 12.41% | 13.14% | 9.40% |

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

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

Overview

For the year ended December 31, 2005, net income amounted to \$1,323,000 compared to net income of \$1,249,000 for the same period in the prior year. Basic and diluted earnings per share, as adjusted for the common stock dividend, were \$0.69 for the year ended December 31, 2005 compared to the prior year earnings per share of \$0.65 per common share. Weighted average shares outstanding for both periods equaled 1,926,656. The 5.92% increase in earnings is primarily attributable to the improving rate environment resulting from the Federal Reserve's increases to the short-term funds rates as well as higher revenues generated through our financial services subsidiary and secondary market mortgage department.. Return on average equity for the period ended December 31, 2005 was 8.35% compared to 8.24% in 2004. Return on average assets for the period ended December 31, 2005 was 0.95% compared to 0.97% in 2004.

Total assets amounted to \$142.2 million on December 31, 2005, an increase of 7.48% or \$9.9 million over the December 31, 2004 level of \$132.3 million. Total loans, as of December 31, 2005, grew to \$94.3 million compared to \$93.7 million as of December 31, 2004. The loan portfolio was up \$0.6 million or 0.64% over the December 31, 2004 level. At year-end 2005, the investment portfolio stood at \$26.3 million, which represents a 24.06% increase over the \$21.2 million prior year-end balance. During the third and fourth quarters, the Bank invested \$3.2 million in six-month time deposit products of a neighboring local financial institution as a yield-enhancing alternative to overnight funds. Overnight federal funds sold increased \$1.7 million, or 68.00%, from \$2.5 million on December 31, 2004 to \$4.2 million on December 31, 2005. Cumulatively, these earning assets grew \$10.6 million or 9.03% during 2005 and represent 90.01% of total assets.

The allowance for loan losses was \$1,025,000 as of December 31, 2005 or 1.09% of loans outstanding, compared to \$1,000,000 as of December 31, 2004 or 1.07% of outstanding loans. The Bank works diligently to maintain quality in its loan portfolio and has historically maintained a delinquency ratio below 1%.

Total deposits amounted to \$110.7 million as of December 31, 2005, which represents a 0.36% decrease from the \$111.1 million level as of December 31, 2004. Total noninterest-bearing demand deposits were \$22.9 million as of December 31, 2005, an increase of \$0.3 million or 1.33% over the December 31, 2004 level. During this same period, interest-bearing deposits declined \$0.7 million or 0.79% from \$88.5 million to \$87.8 million.

Total borrowings from the Federal Home Loan Bank of Atlanta (the "FHLB") increased \$9.6 million from \$4.7 million on December 31, 2004 to \$14.3 million as of December 30, 2005. The Bank expanded its borrowings during a period of very attractive longer-term rates in the second quarter as part of a strategic lending and investing plan designed to capitalize on the flattening yield curve.

Total shareholders' equity was \$15.8 million as of December 31, 2005 and \$15.4 million as of December 31, 2004. The Bank's common stock trades on the Nasdaq Capital Market under the symbol "BOMK".

The Bank's net interest margin was 4.54% for the year ended December 31, 2005 as compared to 4.69% for same period on 2004. The Federal Reserve shifted to a tightening bias at their June 30, 2004 Federal Open Market Committee ("FOMC") meeting with a ¼% increase in the overnight lending rate. Subsequently, four additional increases in 2004 and eight in 2005 followed, each being ¼%, boosting the target Federal Funds rate at year's end to 4.25%. Prudently, the Bank had positioned itself in shorter maturities and variable rate mechanisms in recent years to be properly positioned when rate increases began. While the net interest margin did end the year 15 basis points lower due primarily to the increased borrowings, management believes the short-term yield sacrifice will be well rewarded in the upcoming and future years.

The Bank is not aware of any current recommendations by any regulatory authorities, which, if they were implemented, would have a material effect on the Bank's liquidity, capital resources or results of operations.

Results of Operations

Net Interest Income. The net interest income for the year ended December 31, 2005 was \$5.6 million compared to \$5.3 million for the same period in 2004. This represents an increase of 5.66% over the net interest income earned during the 2004 fiscal year. The average loan portfolio increased \$3.4 million to \$94.2 million for the current fiscal year representing a 3.74% hike over the average loan portfolio assets of \$90.8 million for the same period in 2004. Average investments also climbed \$4.5 million to \$21.6 million for the current fiscal year representing a 26.32% rise over the prior year's average investment portfolio of \$17.1 million. Furthermore, continued FOMC increases in rates have generated substantially higher revenue from overnight funds with little change in average volume. The organization has experienced flatness in core deposits growth during 2005. Average demand deposits increased to \$22.3 million for the 2005 fiscal year as compared to \$20.3 million for the same period in 2004. Average interest bearing deposits were \$89.3 million through December 2005 or \$0.7 million over the average level through December 2004 of \$88.6 million. Finally, average borrowed funds increased \$5.5 million from the December 31, 2004 level of \$4.9 million to the December 31, 2005 level of \$10.4 million.

Interest expense for all interest bearing liabilities amounted to \$2.3 million in 2005, which was \$0.6 million greater than the 2004 level of \$1.7 million. Cost of interest bearing liabilities was 2.30% during 2005 or 44 basis points higher than the 2004 level of 1.86%. This increase is attributable to the higher average borrowings outstanding coupled with an upward trend in rates as the FOMC returns to more of a neutral position.

The Bank's prime based loan portfolio has been positively affected by the interest rate increases experienced during the last eighteen months. Volume growth has slowed during this time; however, the rate growth has had a favorable impact. The interest margin, while lower, has begun to strengthen from its lows and is forecast to continue to improve in the upcoming year.

The table on the following page compares the average balances of key asset and liability categories from 2005 to the year 2004. Average loan balances were \$94.2 million in 2005 as compared to \$90.8 million in 2004. The related interest income from loans was \$6.8 million in 2005 compared to \$6.4 million in 2004. The average yield on loans increased from 7.07% in 2004 to 7.26% in 2005. The investment securities and other earning assets (such as federal funds sold) contributed \$1.1 million to the interest income level of \$7.9 million in 2005. The yield on earning assets was 6.40% in 2005 and 6.22% in 2004. Consistent with asset growth the average interest bearing funding sources (deposit and purchased funds) grew to \$99.7 million in 2005, which was \$6.2 million, or 6.63% greater than the 2004 level of \$93.5 million.

The interest spread again narrowed for the twelve months of 2005 by 26 basis points to 4.10%. Accordingly, the net interest margin decreased for the twelve months of 2005 to 4.54% from 4.69% for the same period in 2004. The decrease in the net interest margin is primarily credited to the increased borrowing relationship with the FHLB. Management elected to lock in long-term funds at a fixed rate in a strategic attempt to offer more flexible credit product durations and enhance long-term earnings. Analysis of the decisions at 2005 year's end has revealed the correctness of the assumptions made at the time the funds were borrowed. Although the initial effects of the decision on interest spread and margin was negative as expected, the credit product terms made available as a result propelled the loan portfolio into growth for the year. The analysis demonstrated the move has surpassed the breakeven point and should add basis points to the margin in future periods.

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, | | | | | |
|---|---------------------------|------------------|-----------------------------|-------------------|------------------|-----------------------------|
| | 2005 | | | 2004 | | |
| | Average Balance | Income / Expense | Yield / ⁽⁴⁾ Rate | Average Balance | Income / Expense | Yield / ⁽⁴⁾ Rate |
| (Dollars in Thousands) | | | | | | |
| Assets: | | | | | | |
| Interest earning assets: | | | | | | |
| Investment securities ⁽¹⁾ | \$ 21,615 | \$ 783 | 3.62% | \$ 17,121 | \$ 600 | 3.50% |
| Loans | 94,174 | 6,841 | 7.26% | 90,780 | 6,416 | 7.07% |
| Interest bearing balances with banks | 1,042 | 40 | 3.84% | - | - | 0.00% |
| Federal funds sold | 6,547 | 228 | 3.48% | 6,112 | 79 | 1.29% |
| Total interest earning assets | <u>123,378</u> | <u>7,892</u> | <u>6.40%</u> | <u>114,013</u> | <u>7,095</u> | <u>6.22%</u> |
| Non-interest earning assets: | | | | | | |
| Cash and due from banks | 5,152 | | | 6,481 | | |
| Premises and equipment | 6,534 | | | 6,646 | | |
| Other assets | 4,827 | | | 3,224 | | |
| Less: Allowance for loan losses | (1,020) | | | (973) | | |
| | <u>15,493</u> | | | <u>15,378</u> | | |
| | <u>\$ 138,871</u> | | | <u>\$ 129,391</u> | | |
| Liabilities and Stockholders' Equity | | | | | | |
| Interest bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | \$ 11,182 | \$ 40 | 0.36% | \$ 11,681 | \$ 42 | 0.36% |
| Money market deposit accounts | 8,308 | 84 | 1.01% | 8,245 | 82 | 0.99% |
| Savings accounts | 13,748 | 82 | 0.60% | 13,357 | 80 | 0.60% |
| Time deposits | 56,074 | 1,593 | 2.84% | 55,270 | 1,303 | 2.36% |
| Total interest-bearing deposits | <u>89,312</u> | <u>1,799</u> | <u>2.01%</u> | <u>88,553</u> | <u>1,507</u> | <u>1.70%</u> |
| Securities sold under repurchase agreements | - | - | 0.00% | 21 | - | 0.00% |
| FHLB Advances | 10,399 | 493 | 4.74% | 4,841 | 232 | 4.79% |
| Other borrowings | 25 | 2 | 8.00% | 47 | 4 | 8.51% |
| Total interest-bearing liabilities | <u>99,736</u> | <u>2,294</u> | <u>2.30%</u> | <u>93,462</u> | <u>1,743</u> | <u>1.86%</u> |
| Non-interest bearing liabilities: | | | | | | |
| Demand deposits | 22,298 | | | 20,349 | | |
| Other liabilities | 984 | | | 422 | | |
| Total liabilities | <u>123,018</u> | | | <u>114,233</u> | | |
| Shareholders' Equity | <u>15,853</u> | | | <u>15,158</u> | | |
| Total Liabilities & Shareholders' Equity | <u>\$ 138,871</u> | | | <u>\$ 129,391</u> | | |
| Interest Spread ⁽²⁾ | | | 4.10% | | | 4.36% |
| Net Interest Margin ⁽³⁾ | | <u>\$ 5,598</u> | 4.54% | | <u>\$ 5,352</u> | 4.69% |

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

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

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

(4) Yields and rates are annualized.

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, 2005 Compared to 2004 | | |
|---|---|---------------|--------------|
| | Change Due To: | | |
| | (Dollars in Thousands) | | |
| | Increase/ (Decrease) | Volume | Rate |
| Interest Earning Assets: | | | |
| Investments | \$ 183 | \$ 162 | \$ 21 |
| Loans | 425 | 247 | 178 |
| Interest bearing time balances with banks | 40 | 40 | - |
| Federal funds sold | 149 | 6 | 143 |
| Total Increase in Interest Income | 797 | 455 | 342 |
| Interest Bearing Liabilities: | | | |
| Interest bearing deposits | 292 | 13 | 279 |
| Borrowed funds | 259 | 263 | (4) |
| Total Increase in Interest Expense | 551 | 276 | 275 |
| Increase in Net Interest Income | \$ 246 | \$ 179 | \$ 67 |

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, 2005. 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, 2005 | | | | | |
| Maturing or Repricing | | | | | |
| | Within | 4 - 12 | 1 -5 | Over | |
| | 3 Months | Months | Years | 5 Years | Total |
| (Dollars in Thousands) | | | | | |
| Interest Earning Assets: | | | | | |
| Investment securities | \$ 59 | \$ 5,275 | \$ 17,808 | \$ 4,142 | \$ 27,284 |
| Loans | 42,466 | 9,610 | 22,400 | 19,558 | 94,034 |
| Interest bearing deposits | 1,515 | 1,500 | - | - | 3,015 |
| Federal funds sold | 4,241 | - | - | - | 4,241 |
| Total interest earning assets | 48,281 | 16,385 | 40,208 | 23,700 | 128,574 |
| Interest bearing liabilities: | | | | | |
| Interest-bearing demand deposits | 10,380 | - | - | - | 10,380 |
| Money market deposit accounts | 8,046 | - | - | - | 8,046 |
| Savings accounts | 13,476 | - | - | - | 13,476 |
| Time deposits & IRAs | 10,750 | 16,981 | 27,810 | 315 | 55,856 |
| Total interest-bearing deposits | 42,652 | 16,981 | 27,810 | 315 | 87,758 |
| Federal funds purchased & securities sold | - | - | | | |
| FHLB Advances | 83 | 250 | 1,333 | 12,667 | 14,333 |
| Other borrowings | 6 | 8 | - | - | 14 |
| Total interest-bearing liabilities | 42,741 | 17,239 | 29,143 | 12,982 | 102,105 |
| Period Gap | \$ 5,540 | \$ (854) | \$ 11,065 | \$ 10,718 | \$ 26,469 |
| Cumulative Gap | \$ 5,540 | \$ 4,686 | \$ 15,751 | \$ 26,469 | \$ 26,469 |
| Cumulative Gap / Total Assets | 3.90% | 3.30% | 11.08% | 18.61% | 18.61% |

The cumulative gap position within three months was \$5,540,000 or +3.90% of total assets as of December 31, 2005. The neutral to slightly positive gap suggests the organization is prepared for rising interest rates, as near-term assets and liabilities will reprice relatively evenly. 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, 2005, the Bank is in an asset sensitive position as expressed by the one-year cumulative “beta” adjusted gap risk ratio of +1.28%. This interest rate risk position generally forecasts a net interest margin that moves in the same direction as market interest rates.

In mid 2004, the Federal Reserve began a tightening cycle as economic signals showed potential inflationary pressures from accelerating growth. By the end of 2004, the prime-lending rate had risen 1¼% to 5.25%. Monetary policy continued to deem further ¼% rate hikes necessary during each of the eight meeting held during 2005. On December 31, 2005 the prime-lending rate had been raised to 7.25%.

The Bank focused on maintaining a shorter duration investment portfolio during 2003 and 2004. The Bank had aggressively promoted loan products with shorter terms and/or floating rate features. During 2005, equity markets attracted investors away from deposit products causing banks to either pay higher than average rates on promotional products or exercise other means to meet liquidity needs. The Bank elected to utilize the latter alternative, and total borrowings from the FHLB increased \$9.6 million from \$4.7 million on December 31, 2004 to \$14.3 million as of December 31, 2005. The Bank expanded its borrowings during a period of very attractive longer-term rates in the second quarter as part of a strategic lending and investing plan designed to capitalize on the flattening yield curve. The Bank began to extend more in the intermediate three to five year term for investments during the fourth quarter, as the FOMC is perceived as nearing the more neutral position. The millennium definitely began by placing challenges on the interest rate risk management process; however, the elections by management to sacrifice earnings and shorten terms to prevent excessive exposure are being rewarded.

Noninterest Income. For the year ended December 31, 2005, noninterest income, exclusive of securities transactions, grew to \$1.43 million, representing a \$60,000 or 4.38% increase over the 2004 level of \$1.37 million. Service charges on deposits were flat during the year and ended with a revenue decrease of \$1,000. Income generated on bank-owned life insurance increased \$34,000 to \$106,000 during 2005 while other income grew \$29,000 from \$579,000 on December 31, 2004 to \$608,000 on December 31, 2005. This 5.01% growth in other income demonstrates success in the Bank’s subsidiary offering insurance and investment products and services. Revenue growth was also experienced by the fixed rate mortgage department despite increasing rate pressure from continued tightening by the FOMC.

Noninterest Expense. Noninterest expense in the 2005 fiscal year amounted to \$5.0 million compared to the 2004 level of \$4.8 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, 2005 was \$3.2 million or \$200,000 higher than the December 31, 2004 level of \$3.0 million. The growth in personnel expense is related to the continued and planned growth of the institution, additional demands in compliance with more recent laws and regulations, and the ever-expanding product array of the company. Occupancy and furniture and equipment costs grew \$11,000 over the 2004 level of \$702,000. Other overhead costs decreased \$8,000, or 0.70%, during 2005 to \$1.1 million. Other overhead costs, while contained in 2005, remain higher due to recent laws and regulations that have mandated the need for additional and/or more extensive audit services.

Income Taxes. For the year ended December 31, 2005, income tax expense grew \$29,000 to \$606,000, a 5.03% increase over the 2004 level of \$577,000. The higher tax expense is directly related to the increase in income earned by the Bank.

Analysis of Financial Condition

Investment Securities. Investment securities available for sale amounted to \$269.3 million as of December 31, 2005, an increase of \$5.1 million or 24.06% in comparison to the December 31, 2004 level of \$21.2 million. No investment securities are classified as held to maturity.

The Bank generally classifies investment securities as available for sale under the classifications required under SFAS No. 115. 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 effects of unrealized losses on the portfolio were an unrealized loss of \$729,000 at December 31, 2005 as compared to an unrealized loss of \$91,000 at December 31, 2004.

The investment portfolio as of December 31, 2005 contains callable U.S. Agency securities, U.S. Agency mortgage backed securities, corporate debt securities, obligations of state and political subdivisions (tax-exempt municipals), certificates of deposit in other banks, 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 following table sets forth a summary of the investment securities portfolio as of the periods indicated:

| | Investment Securities Portfolio Mix | |
|--|--|-------------------------|
| | December 31, | |
| | 2005 | 2004 |
| | (Dollars in Thousands) | |
| Available For Sale Securities | | |
| U.S. Government Agency Securities | \$ 21,785 | \$ 16,910 |
| U.S. Government Agency MBS | 648 | 1,010 |
| Obligations of State/Political Subdivisions | 885 | 499 |
| Corporate Debt Securities | 1,720 | 2,015 |
| Total Available For Sale Securities* | <u>\$ 25,038</u> | <u>\$ 20,434</u> |
| Restricted Securities | | |
| FHLB & FRB Common Stock | 1,211 | 752 |
| Other investments | 54 | 54 |
| Total Restricted Securities | <u>\$ 1,265</u> | <u>\$ 806</u> |
| Total Available For Sale and Restricted Securities | <u><u>\$ 26,303</u></u> | <u><u>\$ 21,240</u></u> |

*AFS investments at estimated fair value

The following table summarizes the contractual maturity of investment securities on an estimated fair value basis and their weighted average yield as of December 31, 2005:

Maturities of Investment Securities

| | Within | | After One Year but Within | | After Five Years but Within | | After Ten Years | | Total | Yield |
|---|-----------------|--------------|------------------------------|--------------|--------------------------------|--------------|-----------------|--------------|------------------|--------------|
| | One Year | | Five Years | | Ten Years | | After Ten Years | | | |
| | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield | | |
| (Dollars in Thousands) | | | | | | | | | | |
| Available For Sale Securities | | | | | | | | | | |
| US Government Agency Securities | \$ 2,869 | 2.57% | \$ 16,634 | 3.54% | \$ 2,282 | 5.18% | \$ - | 0.00% | \$ 21,785 | 3.58% |
| US Government Agency MBS | - | 0.00% | 648 | 2.83% | - | 0.00% | - | 0.00% | 648 | 2.83% |
| Obligations of State/Political Subdivisions | 184 | 3.48% | 124 | 4.71% | 577 | 4.99% | - | 0.00% | 885 | 4.64% |
| Corporate debt and Other securities | - | 0.00% | 1,720 | 4.58% | - | 0.00% | - | 0.00% | 1,720 | 4.58% |
| Restricted securities | - | 0.00% | - | 0.00% | - | 0.00% | 1,265 | 4.29% | 1,265 | 4.29% |
| Total Available For Sale Securities | \$ 3,053 | 2.62% | \$ 19,126 | 3.62% | \$ 2,859 | 5.14% | \$ 1,265 | 4.29% | \$ 26,303 | 3.65% |

Contractual maturities of mortgage-backed securities (MBS) are 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 specified contractual maturities by their respective issuers.

Loan Portfolio. The loan portfolio was \$94.3 million as of December 31, 2005, compared to \$93.7 million as of December 31, 2004. Commercial loans represent 8.86% of the loan portfolio or \$8.4 million as of December 31, 2005. Commercial real estate loans (generally owner occupied) were \$42.2 million or 44.69% of the loan portfolio at year's end. Residential real estate loans (home equity and fixed rate trusts) were \$35.3 million or 37.46% of the portfolio while consumer, real estate construction and other loans make up the balance of the loan portfolio as of December 31, 2005. 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 and Chesterfield as well as the city of Colonial Heights.

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

Loan Portfolio Mix

December 31,

| | 2005 | | 2004 | |
|--------------------------|------------------|----------------|------------------|----------------|
| | Amount | Percentage | Amount | Percentage |
| (Dollars in Thousands) | | | | |
| Commercial | \$ 8,357 | 8.86% | \$ 8,880 | 9.48% |
| Commercial real estate | 42,153 | 44.69% | 44,947 | 47.97% |
| Real estate construction | 5,185 | 5.50% | 4,006 | 4.27% |
| Residential real estate | 35,336 | 37.46% | 32,051 | 34.20% |
| Consumer | 3,288 | 3.49% | 3,806 | 4.06% |
| Other | - | 0.00% | 18 | 0.02% |
| Total loans | \$ 94,319 | 100.00% | \$ 93,708 | 100.00% |

The following table presents the maturities or re-pricing periods of selected loans outstanding at the year ended December 31, 2005.

Loan Maturity Distribution

| | December 31, 2005 | | | |
|--------------------------|------------------------|--------------------------------------|------------------|-----------|
| | One Year or Less | After One Year Through Five Years | After Five Years | Total |
| | (Dollars in Thousands) | | | |
| Commercial | \$ 3,718 | \$ 4,467 | \$ 172 | \$ 8,357 |
| Real Estate | 11,486 | 19,370 | 46,633 | 77,489 |
| Real Estate Construction | 3,923 | 1,261 | - | 5,184 |
| Installment | 628 | 2,021 | 95 | 2,744 |
| Credit Card Lines | 545 | - | - | 545 |
| | \$ 20,300 | \$ 27,119 | \$ 46,900 | \$ 94,319 |
| Loans with: | | | | |
| Fixed Rates | \$ 11,921 | \$ 22,685 | \$ 19,558 | \$ 54,164 |
| Variable Rates | 8,379 | 4,433 | 27,342 | 40,154 |
| | \$ 20,300 | \$ 27,119 | \$ 46,900 | \$ 94,319 |

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 \$1,025,000 as of December 31, 2005 or 1.09% of loans outstanding compared to \$1,000,000 as of December 31, 2004 or 1.07% of outstanding loans.

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

Allowance for Loan Losses

| | December 31, | |
|--|------------------------|-----------------|
| | 2005 | 2004 |
| | (Dollars in Thousands) | |
| Balance, beginning of period | \$ 1,000 | \$ 900 |
| Provision for loan losses | 41 | 102 |
| Chargeoffs: | | |
| Commerical | 18 | - |
| Consumer | 19 | 13 |
| Total chargeoffs | <u>37</u> | <u>13</u> |
| Recoveries: | | |
| Commerical | 8 | - |
| Consumer | 13 | 11 |
| Total recoveries | <u>21</u> | <u>11</u> |
| Net chargeoffs | <u>16</u> | <u>2</u> |
| Balance, end of period | <u>\$ 1,025</u> | <u>\$ 1,000</u> |
| Allowance for loan losses to total loans | <u>1.09%</u> | <u>1.07%</u> |
| Net chargeoffs to average loans | <u>0.02%</u> | <u>0.00%</u> |

A breakdown of the allowance for loan losses is provided in the following table. 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, | |
|----------------------------------|------------------------|-----------------|
| | 2005 | 2004 |
| | (Dollars in Thousands) | |
| Commercial | \$ 308 | \$ 315 |
| Commercial real estate | 205 | 180 |
| Real estate construction | 51 | 70 |
| Residential real estate | 205 | 202 |
| Consumer | <u>256</u> | <u>233</u> |
| Total Allowance for Loans Losses | <u>\$ 1,025</u> | <u>\$ 1,000</u> |

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 and general economic conditions. On December 31, 2005, past dues stood at \$245,000 or 0.26% of year-end loans as compared to \$629,000 or 0.67% of total loans outstanding for December 31, 2004. 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 or when principal or interest is delinquent in excess of 90 days. On December 31, 2005, non-performing assets stood at \$1.8 million or 1.86% of year-end loans. This compared to the \$1.6 million non-performing balance, or 1.71%, of total loans outstanding for December 31, 2004.

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, | |
|---|------------------------|----------|
| | 2005 | 2004 |
| | (Dollars in Thousands) | |
| Non-Performing Assets: | | |
| Impaired Loans | \$ 1,468 | \$ 1,544 |
| Non-Accruing Loans | 285 | 61 |
| Other Real Estate Owned | - | - |
| Total Non-Performing Assets: | \$ 1,753 | \$ 1,605 |
| Past Due Loans: | | |
| Commerical | \$ 20 | \$ 28 |
| Real estate | 205 | 571 |
| Consumer | 20 | 30 |
| Total Past Due Loans | \$ 245 | \$ 629 |
| Non-Performing Assets to Total Loans | 1.86% | 1.71% |
| Past Due Loans to Total Loans | 0.26% | 0.67% |
| Past due and Non-Performing Assets to Total Loans | 2.12% | 2.38% |

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, 2005 the deposit portfolio retracted slightly to \$110.7 million, a \$0.4 million decrease over the December 31, 2004 level of \$111.1 million. The organization has seen money-flows out of deposit products into the equity market as investors felt more comfortable with the economy's improving strength. Non-interest bearing demand deposits did grow however by 1.33%, or \$0.3 million, to a December 31, 2005 level of 22.9 million. Time deposits remained slow during 2005 as well as investors were enticed away from the safety and security of the banking system. Time instruments increased \$0.7 million over the December 31, 2004 balance of \$55.2 million to \$55.9 million, an increase of 1.27%. Other interest bearing deposits fell 4.20% or \$1.4 million and ended the year at a level of \$31.9 million. As of December 31, 2005 and 2004, 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, | | | | | |
| | 2005 | | | 2004 | | |
| Average Balance | Interest Expense | Average Rate | Average Balance | Interest Expense | Average Rate | |
| (Dollars in Thousands) | | | | | | |
| Interest bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | \$ 11,182 | \$ 40 | 0.36% | \$ 11,681 | \$ 42 | 0.36% |
| Money market deposit accounts | 8,308 | 84 | 1.01% | 8,245 | 82 | 0.99% |
| Savings accounts | 13,748 | 82 | 0.60% | 13,357 | 80 | 0.60% |
| Time deposits | 56,074 | 1,593 | 2.84% | 55,270 | 1,303 | 2.36% |
| Total interest-bearing deposits | <u>89,312</u> | <u>\$ 1,799</u> | <u>2.01%</u> | <u>88,553</u> | <u>\$ 1,507</u> | <u>1.70%</u> |
| Non-interest bearing deposits | <u>22,298</u> | | | <u>20,349</u> | | |
| Total deposits | <u>\$ 111,610</u> | | | <u>\$ 108,902</u> | | |

The following is a summary of maturity distributions of certificates of deposit as of December 31, 2005.

| | Certificate of Deposit Maturity Distribution | | | |
|------------------------------------|---|----------------------------------|-----------------------|------------------|
| | December 31, 2005 | | | |
| | Three Months or Less | Three Months to Twelve Months | Over Twelve Months | Total |
| (Dollars in Thousands) | | | | |
| Certificates of Deposit: | | | | |
| Less than \$100,000 | \$ 6,335 | \$ 13,004 | \$ 22,059 | \$ 41,398 |
| Greater than or equal to \$100,000 | 4,415 | 3,978 | 6,065 | 14,458 |
| Total Certificates of Deposit | <u>\$ 10,750</u> | <u>\$ 16,982</u> | <u>\$ 28,124</u> | <u>\$ 55,856</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, 2005 and 2004 are \$14,347,780 and \$4,702,077 respectively. At December 31, 2005, the following scheduled debt payments are due:

| | |
|------------|----------------------|
| 2006 | \$ 347,780 |
| 2007 | 333,333 |
| 2008 | 333,333 |
| 2009 | 333,333 |
| 2010 | 333,333 |
| Thereafter | <u>12,666,668</u> |
| | <u>\$ 14,347,780</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, 2005 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, 2005 and 2004, is as follows:

| | <u>December 31,</u> | |
|---|---------------------|--------------|
| | <u>2005</u> | <u>2004</u> |
| Financial instruments whose contract amounts represent credit risk: | | |
| Commitments to extend credit | \$ 10,998,124 | \$ 9,071,510 |
| Federal Home Loan Bank letter of credit to secure public deposits | 2,750,000 | 2,250,000 |
| Standby letters of credit | 896,334 | 518,082 |

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 \$15.8 million on December 31, 2005 and \$15.4 million on December 31, 2004. 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 25% to 35% of fiscal net earnings. A \$0.22 per common share dividend or 32.03% of earnings was declared in December of 2005, a \$0.02 or 10% increase over the December cash dividend per common share of \$0.20 declared in 2004. The December 2004 cash dividend represented 30.85% of fiscal 2004 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, | |
|---|------------------------|-------------------|
| | 2005 | 2004 |
| | (Dollars in Thousands) | |
| Tier 1 Capital: | | |
| Common stock | \$ 3,853 | \$ 3,853 |
| Capital surplus | 5,894 | 5,894 |
| Retained earnings | 6,035 | 5,617 |
| Reverse: Unrealized Gains/Losses | 647 | 166 |
| Total tier 1 capital | <u>16,429</u> | <u>15,530</u> |
| Tier 2 Capital: | | |
| Allowance for loan losses | <u>1,025</u> | <u>1,000</u> |
| Tier 3 Capital: | | |
| Deduction for Investments in Financial Subsidiaries | <u>(140)</u> | <u>(140)</u> |
| Total Risk Based Capital | <u>\$ 17,314</u> | <u>\$ 16,390</u> |
| Risk weighted assets | <u>\$ 102,422</u> | <u>\$ 100,835</u> |
| Quarterly average assets | <u>\$ 144,569</u> | <u>\$ 132,277</u> |

| | December 31, | | Regulatory |
|---------------------------------|--------------|-------|------------|
| | 2005 | 2004 | Minimum |
| Capital Ratios: | | | |
| Tier 1 risk based capital ratio | 16.0% | 15.4% | 4.0% |
| Total risk based capital ratio | 16.8% | 16.1% | 8.0% |
| Leverage ratio | 11.3% | 11.7% | 4.0% |

Return on Average Assets and Average Equity

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

| | December 31, | |
|--|------------------------|------------|
| | 2005 | 2004 |
| | (Dollars in Thousands) | |
| Average total assets | \$ 138,871 | \$ 129,391 |
| Average shareholders' equity | \$ 15,853 | \$ 15,158 |
| Net income | \$ 1,323 | \$ 1,249 |
| Cash dividends declared | \$ 424 | \$ 385 |
| Return on average assets | 0.95% | 0.97% |
| Return on average shareholders' equity | 8.35% | 8.24% |
| Average shareholders' equity to average total assets | 11.42% | 11.71% |

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 7. Financial Statements



Yount, Hyde & Barbour, P.C.
Certified Public Accountants
and Consultants

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
Bank of McKenney
McKenney, Virginia

We have audited the consolidated balance sheets of Bank of McKenney and subsidiary as of December 31, 2005 and 2004, 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, 2005. 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. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included 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, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
February 8, 2006

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 2005 and 2004

| Assets | 2005 | 2004 |
|---|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Cash and due from banks | \$ 3,452,836 | \$ 4,717,886 |
| Federal funds sold | 4,241,000 | 2,526,000 |
| Interest-bearing time deposits in banks | 3,015,123 | -- |
| Securities available for sale, at fair market value | 25,037,717 | 20,433,458 |
| Restricted investments | 1,265,225 | 806,825 |
| Loans, net of allowance for loan losses of \$1,025,000 in 2005 and \$1,000,000 in 2004 | 93,293,989 | 92,708,341 |
| Land, premises and equipment, net | 6,744,063 | 6,558,878 |
| Accrued interest receivable | 637,989 | 522,562 |
| Bank owned life insurance | 2,764,195 | 2,658,001 |
| Other assets | <u>1,749,936</u> | <u>1,339,141</u> |
| Total assets | <u>\$ 142,202,073</u> | <u>\$ 132,271,092</u> |
| Liabilities and Shareholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Noninterest-bearing | \$ 22,904,888 | \$ 22,582,566 |
| Interest-bearing | <u>87,758,128</u> | <u>88,487,138</u> |
| Total deposits | \$ 110,663,016 | \$ 111,069,704 |
| Borrowed funds | 14,347,780 | 4,702,077 |
| Accrued interest payable | 218,214 | 163,123 |
| Accrued expenses and other liabilities | <u>1,190,566</u> | <u>972,241</u> |
| Total liabilities | <u>\$ 126,419,576</u> | <u>\$ 116,907,145</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 | 6,682,012 | 5,782,627 |
| Accumulated other comprehensive loss | <u>(646,785)</u> | <u>(165,950)</u> |
| Total shareholders' equity | <u>\$ 15,782,497</u> | <u>\$ 15,363,947</u> |
| Total liabilities and shareholders' equity | <u>\$ 142,202,073</u> | <u>\$ 132,271,092</u> |

See Notes to Consolidated Financial Statements.

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Statements of Income

For the Three Years Ended December 31, 2005

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|---------------------|---------------------|---------------------|
| Interest and Dividend Income | | | |
| Interest and fees on loans | \$ 6,840,912 | \$ 6,416,788 | \$ 5,950,271 |
| Interest and dividends on securities - taxable | 753,393 | 573,923 | 514,919 |
| Interest on securities - nontaxable | 19,446 | 17,749 | 50,211 |
| Interest on deposits in banks | 53,681 | 5,025 | 8,163 |
| Interest on federal funds sold | 214,390 | 73,748 | 82,537 |
| Total interest and dividend income | <u>\$ 7,881,822</u> | <u>\$ 7,087,233</u> | <u>\$ 6,606,101</u> |
| Interest Expense | | | |
| Interest on deposits | \$ 1,799,437 | \$ 1,506,670 | \$ 1,605,113 |
| Interest on borrowed funds | 494,689 | 235,808 | 12,435 |
| Total interest expense | <u>\$ 2,294,126</u> | <u>\$ 1,742,478</u> | <u>\$ 1,617,548</u> |
| Net interest income | \$ 5,587,696 | \$ 5,344,755 | \$ 4,988,553 |
| Provision for loan losses | 41,464 | 102,321 | 125,682 |
| Net interest income after provision for loan losses | <u>\$ 5,546,232</u> | <u>\$ 5,242,434</u> | <u>\$ 4,862,871</u> |
| Noninterest Income | | | |
| Service charges on deposit accounts | \$ 716,704 | \$ 717,838 | \$ 632,241 |
| Net gain (loss) on sales of available for sale securities | (1,484) | 58,422 | 208,744 |
| Bank-owned life insurance | 106,194 | 71,935 | 48,469 |
| Other operating income | 594,161 | 571,127 | 681,296 |
| Gain (loss) on sale of fixed assets | 13,924 | 7,628 | (2,962) |
| Total noninterest income | <u>\$ 1,429,499</u> | <u>\$ 1,426,950</u> | <u>\$ 1,567,788</u> |
| Noninterest Expense | | | |
| Salaries and employee benefits | \$ 3,195,382 | \$ 3,008,547 | \$ 2,831,926 |
| Occupancy expense | 295,263 | 285,580 | 262,256 |
| Furniture and equipment expense | 417,948 | 416,790 | 375,053 |
| Data processing | 112,612 | 134,357 | 99,291 |
| Telecommunications | 93,584 | 93,951 | 78,005 |
| Stationery and supplies | 106,638 | 120,838 | 135,148 |
| Audit and accounting fees | 130,740 | 132,030 | 101,440 |
| Corporate franchise tax | 113,083 | 103,214 | 106,699 |
| Other operating expenses | 581,581 | 548,604 | 507,077 |
| Total noninterest expenses | <u>\$ 5,046,831</u> | <u>\$ 4,843,911</u> | <u>\$ 4,496,895</u> |
| Income before income taxes | \$ 1,928,900 | \$ 1,825,473 | \$ 1,933,764 |
| Income tax expense | 605,651 | 576,538 | 633,326 |
| Net income | <u>\$ 1,323,249</u> | <u>\$ 1,248,935</u> | <u>\$ 1,300,438</u> |
| Earnings per Share | | | |
| Net income, basic and diluted | <u>\$ 0.69</u> | <u>\$ 0.65</u> | <u>\$ 0.67</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, 2005

| | <u>Common</u> | | <u>Retained</u> | <u>Accumulated</u> | | |
|---|---------------------|---------------------|---------------------|----------------------|----------------------|----------------------|
| | <u>Stock</u> | <u>Surplus</u> | <u>Earnings</u> | <u>Other</u> | <u>Comprehensive</u> | <u>Total</u> |
| | | | | <u>Income (Loss)</u> | <u>Income</u> | |
| Balance at December 31, 2002 | \$ 3,853,312 | \$ 5,893,958 | \$ 3,946,117 | \$ 53,886 | | \$ 13,747,273 |
| Comprehensive income: | | | | | | |
| Net income | -- | -- | 1,300,438 | -- | \$ 1,300,438 | 1,300,438 |
| Other comprehensive loss: | | | | | | |
| Unrealized holding losses on securities available for sale arising during the period, net of tax benefit of (\$11,460) | -- | -- | -- | -- | (22,245) | -- |
| Less reclassification adjustment, net of tax of (\$70,973) | -- | -- | -- | -- | <u>(137,771)</u> | -- |
| Other comprehensive loss, net of tax | -- | -- | -- | (160,016) | <u>\$ (160,016)</u> | (160,016) |
| Total comprehensive income | | | | | <u>\$ 1,140,422</u> | |
| Cash dividends declared (\$.17 per share) | <u>--</u> | <u>--</u> | <u>(327,532)</u> | <u>--</u> | | <u>(327,532)</u> |
| Balance at December 31, 2003 | \$ 3,853,312 | \$ 5,893,958 | \$ 4,919,023 | \$ (106,130) | | \$ 14,560,163 |
| Comprehensive income: | | | | | | |
| Net income | -- | -- | 1,248,935 | -- | \$ 1,248,935 | 1,248,935 |
| Other comprehensive loss: | | | | | | |
| Unrealized holding losses on securities available for sale arising during the period, net of tax benefit of (\$10,953) | -- | -- | -- | -- | (21,261) | -- |
| Less reclassification adjustment, net of tax of (\$19,863) | -- | -- | -- | -- | <u>(38,559)</u> | -- |
| Other comprehensive loss, net of tax | -- | -- | -- | (59,820) | <u>\$ (59,820)</u> | (59,820) |
| Total comprehensive income | | | | | <u>\$ 1,189,115</u> | |
| Cash dividends declared (\$.20 per share) | <u>--</u> | <u>--</u> | <u>(385,331)</u> | <u>--</u> | | <u>(385,331)</u> |
| Balance at December 31, 2004 | \$ 3,853,312 | \$ 5,893,958 | \$ 5,782,627 | \$ (165,950) | | \$ 15,363,947 |
| Comprehensive income: | | | | | | |
| Net income | -- | -- | 1,323,249 | -- | \$ 1,323,249 | 1,323,249 |
| Other comprehensive loss: | | | | | | |
| Unrealized holding losses on securities available for sale arising during the period, net of tax benefit of (\$248,207) | -- | -- | -- | -- | (481,814) | -- |
| Add reclassification adjustment, net of tax benefit of \$505 | -- | -- | -- | -- | <u>979</u> | -- |
| Other comprehensive loss, net of tax benefit | -- | -- | -- | (480,835) | <u>\$ (480,835)</u> | (480,835) |
| Total comprehensive income | | | | | <u>\$ 842,414</u> | |
| Cash dividends declared (\$.22 per share) | <u>--</u> | <u>--</u> | <u>(423,864)</u> | <u>--</u> | | <u>(423,864)</u> |
| Balance at December 31, 2005 | <u>\$ 3,853,312</u> | <u>\$ 5,893,958</u> | <u>\$ 6,682,012</u> | <u>\$ (646,785)</u> | | <u>\$ 15,782,497</u> |

See Notes to Consolidated Financial Statements.

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Statements of Cash Flows
For the Three Years Ended December 31, 2005

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|------------------------|------------------------|------------------------|
| Cash Flows from Operating Activities | | | |
| Net income | \$ 1,323,249 | \$ 1,248,935 | \$ 1,300,438 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 453,179 | 457,398 | 422,444 |
| Provision for loan losses | 41,464 | 102,321 | 125,682 |
| Net (gain) loss on sales of securities available for sale | 1,484 | (58,422) | (208,744) |
| Net (gain) loss on sale of fixed assets | (13,424) | (7,628) | 2,962 |
| Net (gain) on sale of other assets | (500) | - | - |
| Net amortization of premium on securities | 23,417 | 14,901 | 30,870 |
| Deferred tax (benefit) | (78,708) | (67,496) | (34,333) |
| Changes in assets and liabilities: | | | |
| (Increase) decrease in accrued interest receivable | (115,427) | (68,809) | 9,706 |
| (Increase) in other assets | (191,078) | (202,841) | (128,760) |
| Increase (decrease) in accrued interest payable | 55,091 | 7,210 | (33,124) |
| Increase in accrued expenses and other liabilities | 179,792 | 143,903 | 48,368 |
| Net cash provided by operating activities | <u>\$ 1,678,539</u> | <u>\$ 1,569,472</u> | <u>\$ 1,535,509</u> |
| Cash Flows from Investing Activities | | | |
| Net change in interest-bearing deposits in banks | \$ (3,015,123) | \$ - | \$ 199,953 |
| Activity in available for sale securities: | | | |
| Sales | 291,156 | 5,817,951 | 7,966,563 |
| Maturities, prepayments and calls | 1,350,984 | 4,664,669 | 12,565,153 |
| Purchases | (6,999,838) | (13,495,775) | (25,994,525) |
| Purchase of restricted securities | (458,400) | (151,400) | (51,600) |
| Purchase of bank owned life insurance | - | (1,500,000) | - |
| Net increase in loans | (627,112) | (7,506,414) | (13,085,340) |
| Purchases of land, premises and equipment | (642,840) | (259,518) | (1,282,970) |
| Proceeds from sale of fixed assets | 17,900 | 18,750 | 5,300 |
| Proceeds from sale of other assets | 1,000 | - | - |
| Net cash used in investing activities | <u>\$ (10,082,273)</u> | <u>\$ (12,411,737)</u> | <u>\$ (19,677,466)</u> |

See Notes to Consolidated Financial Statements.

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Statements of Cash Flows

(Continued)

For the Three Years Ended December 31, 2005

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|---------------------|---------------------|----------------------|
| Cash Flows from Financing Activities | | | |
| Net increase in deposits | \$ (406,688) | \$ 7,313,107 | \$ 13,390,652 |
| Dividends paid | (385,331) | (327,532) | (288,998) |
| Net change in securities sold under agreements to repurchase | - | (17,141) | 17,141 |
| Federal Home Loan Bank advances | 10,000,000 | - | 5,000,000 |
| Payments on FHLB advances and other borrowed funds | <u>(354,297)</u> | <u>(354,666)</u> | <u>(219,722)</u> |
| Net cash provided by financing activities | <u>\$ 8,853,684</u> | <u>\$ 6,613,768</u> | <u>\$ 17,899,073</u> |
| | | | |
| Net increase (decrease) in cash and cash equivalents | \$ 449,950 | \$ (4,228,497) | \$ (242,884) |
| | | | |
| Cash and Cash Equivalents | | | |
| Beginning of year | <u>7,243,886</u> | <u>11,472,383</u> | <u>11,715,267</u> |
| | | | |
| End of year | <u>\$ 7,693,836</u> | <u>\$ 7,243,886</u> | <u>\$ 11,472,383</u> |
| | | | |
| Supplemental Disclosures of Cash Flow Information | | | |
| Cash paid during the year for: | | | |
| Interest | <u>\$ 2,239,035</u> | <u>\$ 1,735,268</u> | <u>\$ 1,650,672</u> |
| | | | |
| Income taxes | <u>\$ 671,057</u> | <u>\$ 654,150</u> | <u>\$ 699,140</u> |
| | | | |
| Supplemental Disclosures of Noncash Investing and Financing Activities | | | |
| | | | |
| Fair value adjustment for securities | <u>\$ (728,539)</u> | <u>\$ (90,637)</u> | <u>\$ (242,450)</u> |
| | | | |
| Capitalized interest | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 22,187</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 and Chesterfield and the city of Colonial Heights 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, Bankers Insurance 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 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 special mention. 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.

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, 2005, 2004 and 2003.

Earnings and dividends per share are computed based on 1,926,656 weighted average shares outstanding during 2005, 2004 and 2003.

Advertising

The Bank follows the policy of charging the costs of advertising to expense as incurred. Total advertising expense incurred for 2005, 2004 and 2003 was \$61,384, \$36,573 and \$36,715, 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 November 2005, the Financial Accounting Standards Board ("FASB") Staff Position ("FSP") 115-1 "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" was issued. The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock". The FSP applies to investments in debt and equity securities and cost-method investments. The application guidance within the FSP includes items to consider in determining whether an investment is impaired, in evaluating if an impairment is other than temporary and recognizing impairment losses equal to the difference between the investment's cost and its fair value when an impairment is determined. The FSP is required for all reporting periods beginning after December 15, 2005. Earlier application is permitted. The Bank does not anticipate the amendment will have a material effect on its financial statements.

In May 2005, the FASB issued Statement No. 154, ("SFAS No. 154") "Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3." The new standard changes the requirements for the accounting for and reporting of a change in accounting principle. Among other changes, SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a "restatement." The new standard is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Bank does not anticipate this revision will have a material effect on its financial statements.

In December 2004, the FASB issued Statement No. 123 (Revised 2004) (SFAS No. 123R) "Share-Based Payment", which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. SFAS No. 123R replaces SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." Share-based compensation arrangements include share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. SFAS No. 123R requires all share-based payments to employees to be valued using a fair value method on the date of grant and expensed based on that fair value over the applicable vesting period. SFAS No. 123R also amends SFAS No. 95 "Statement of Cash Flows" requiring the benefits of tax deductions in excess of recognized compensation cost be reported as financing instead of operating cash flows. The Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107"), which expresses the SEC's views regarding the interaction between SFAS No. 123R and certain SEC rules and regulations. Additionally, SAB No. 107 provides guidance related to share-based payment transactions for public companies. The Bank will be required to apply SFAS No. 123R as of the annual reporting period that begins after September 15, 2005. The Bank does not currently offer, or plan to offer, any forms of share-based compensation. No material impact on financial statements is anticipated in the future.

In December 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer" ("SOP 03-3"). SOP 03-3 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes loans purchased by the Bank or acquired in business combinations. SOP 03-3 does not apply to loans originated by the Corporation. The Corporation adopted the provisions of SOP 03-3 effective January 1, 2005. The initial implementation had no material effect on the Bank's financial statements.

Note 2. Securities

The amortized cost and fair value of securities, with gross unrealized gains and losses at December 31, 2005 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 | \$ 2,021,037 | \$ -- | \$ (300,787) | \$ 1,720,250 |
| Mortgage-backed securities | 670,056 | -- | (22,440) | 647,616 |
| Government agencies | 22,425,528 | 4 | (640,778) | 21,784,754 |
| Tax-exempt municipals | 901,074 | - | (15,977) | 885,097 |
| | <u>\$ 26,017,695</u> | <u>\$ 4</u> | <u>\$ (979,982)</u> | <u>\$ 25,037,717</u> |

The amortized cost and fair value of securities, with gross unrealized gains and losses at December 31, 2004 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 | \$ 2,029,491 | \$ 4,364 | \$ (18,856) | \$ 2,014,999 |
| Mortgage-backed securities | 1,017,980 | 50 | (8,487) | 1,009,543 |
| Government agencies | 17,149,957 | 5,433 | (244,930) | 16,910,460 |
| Tax-exempt municipals | 487,469 | 13,084 | (2,097) | 498,456 |
| | <u>\$ 20,684,897</u> | <u>\$ 22,931</u> | <u>\$ (274,370)</u> | <u>\$ 20,433,458</u> |

The contractual maturities of investment securities classified as available for sale at December 31, 2005 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>Amortized Cost</u> | <u>Fair Value</u> |
|---|---------------------------|-----------------------|
| Available for Sale | | |
| Maturing within one year | \$ 3,123,525 | \$ 3,053,519 |
| Maturing after one year, but within five years | 20,017,813 | 19,125,861 |
| Maturing after five years, but within ten years | 2,876,357 | 2,858,337 |
| | <u>\$ 26,017,695</u> | <u>\$ 25,037,717</u> |

Proceeds from sales of securities available for sale for the years ended December 31, 2005, 2004 and 2003, amounted to \$291,156, \$5,817,951 and \$7,966,563, respectively. Gross realized gains (losses) amounted to (\$1,484), \$58,422 and \$208,744, respectively.

Notes to Consolidated Financial Statements

There were no securities pledged to secure public deposits or for other purposes required by law at December 31, 2005 or December 31, 2004. 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 \$1,265,255 and \$806,825 at December 31, 2005 and 2004, 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, 2005 and 2004 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, 2005 and 2004 is as follows:

| Description | Total | | December 31, 2005 | | | |
|---------------------------|----------------------|---------------------|---------------------|---------------------|----------------------|---------------------|
| | Fair Value | Unrealized Loss | Less than 12 Months | | 12 Months or Greater | |
| | | | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Government agencies | \$ 19,790,377 | \$ (640,778) | \$ 7,315,195 | \$ (105,960) | \$ 12,475,182 | \$ (534,818) |
| Mortgage-backed | 647,616 | (22,440) | 18,588 | (213) | 629,028 | (22,227) |
| Corporate | 1,720,250 | (300,787) | 861,250 | (153,883) | 859,000 | (146,904) |
| Tax exempt municipals | <u>885,097</u> | <u>(15,977)</u> | <u>700,977</u> | <u>(15,097)</u> | <u>184,120</u> | <u>(880)</u> |
| Unrealized Loss Positions | <u>\$ 23,043,340</u> | <u>\$ (979,982)</u> | <u>\$ 8,896,010</u> | <u>\$ (275,153)</u> | <u>\$ 14,147,330</u> | <u>\$ (704,829)</u> |

| Description | Total | | December 31, 2004 | | | |
|---------------------------|----------------------|---------------------|---------------------|---------------------|----------------------|---------------------|
| | Fair Value | Unrealized Loss | Less than 12 Months | | 12 Months or Greater | |
| | | | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Government agencies | \$ 12,430,070 | \$ (244,930) | \$ 6,589,832 | \$ (85,168) | \$ 5,840,238 | \$ (159,762) |
| Mortgage-backed | 985,006 | (8,487) | - | - | 985,006 | (8,487) |
| Corporate | 990,000 | (18,856) | 990,000 | (18,856) | - | - |
| Tax exempt municipals | <u>197,903</u> | <u>(2,097)</u> | <u>-</u> | <u>-</u> | <u>197,903</u> | <u>(2,097)</u> |
| Unrealized Loss Positions | <u>\$ 14,602,979</u> | <u>\$ (274,370)</u> | <u>\$ 7,579,832</u> | <u>\$ (104,024)</u> | <u>\$ 7,023,147</u> | <u>\$ (170,346)</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, 2005, the securities identified above with unrealized losses consisted of sixteen U.S. Agency issues, two governmental mortgage pool issues, two corporate issues, and five issues of different municipalities. During the year, the two corporate credits, General Motors Acceptance Corporation and Ford Motor Credits were both downgraded to sub-investment grade. With the issuance being through the financing arms and the maturity being short (approximately two years), no losses are expected at this time. All agency, mortgage and municipal bonds were purchased during or after 2003, and the unrealized losses reflect changes in the current interest rate environment 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 securities are issued by the federal government or its agencies, 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, 2005 and 2004 is as follows:

| | <u>2005</u> | <u>2004</u> |
|---------------------------------|----------------------|----------------------|
| Commercial | \$ 8,356,909 | \$ 8,880,324 |
| Real estate | 77,489,089 | 76,997,697 |
| Real estate-construction | 5,184,578 | 4,006,404 |
| Installment | 2,743,851 | 3,249,261 |
| Credit cards | 544,562 | 556,766 |
| Lease financing | - | 17,889 |
| Total loans | <u>\$ 94,318,989</u> | <u>\$ 93,708,341</u> |
| Less: Allowance for loan losses | <u>1,025,000</u> | <u>1,000,000</u> |
| Loans, net | <u>\$ 93,293,989</u> | <u>\$ 92,708,341</u> |

Note 4. Allowance for Loan Losses

Activity in the allowance for loan losses for the years ended December 31, 2005, 2004 and 2003 is as follows:

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|--------------------|---------------------|---------------------|-------------------|
| Balance, beginning | \$ 1,000,000 | \$ 900,000 | \$ 800,000 |
| Loans charged off | (37,515) | (13,182) | (41,333) |
| Recoveries | 21,051 | 10,861 | 15,651 |
| Provision | 41,464 | 102,321 | 125,682 |
| Balance, ending | <u>\$ 1,025,000</u> | <u>\$ 1,000,000</u> | <u>\$ 900,000</u> |

The following is a summary of information pertaining to impaired loans at December 31, 2005, 2004 and 2003:

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|---------------------|---------------------|------------------|
| Impaired loans with a valuation allowance | \$ 1,752,716 | \$ 1,604,844 | \$ 71,916 |
| Impaired loans without a valuation allowance | <u>--</u> | <u>--</u> | <u>--</u> |
| Total impaired loans | <u>\$ 1,752,716</u> | <u>\$ 1,604,844</u> | <u>\$ 71,916</u> |
| Valuation allowance related to impaired loans | <u>\$ 642,500</u> | <u>\$ 615,000</u> | <u>\$ 35,958</u> |
| Average investment in impaired loans | <u>\$ 1,633,576</u> | <u>\$ 819,226</u> | <u>\$ 71,916</u> |
| Interest income recognized | <u>\$ 114,876</u> | <u>\$ 58,305</u> | <u>\$ --</u> |

There were no non-accrual loans excluded from impaired loan disclosure under FASB 114 at December 31, 2005, 2004 and 2003.

Note 5. Land, Premises and Equipment

Land, premises, and equipment at December 31, 2005 and 2004 are composed of the following:

| | 2005 | 2004 |
|------------------------------------|--------------|--------------|
| Land | \$ 1,459,598 | \$ 1,144,744 |
| Bank building and improvements | 5,505,444 | 5,444,071 |
| Furniture and equipment | 2,130,869 | 2,156,805 |
| Automobiles | 336,136 | 311,242 |
| Total land, premises and equipment | \$ 9,432,047 | \$ 9,056,862 |
| Less accumulated depreciation | 2,687,984 | 2,497,984 |
| Net land, premises and equipment | \$ 6,744,063 | \$ 6,558,878 |

Depreciation expense for the years ended December 31, 2005, 2004 and 2003 amounted to \$453,179, \$457,398 and \$422,444, respectively.

Note 6. Deposits

The aggregate amounts of time deposits in denominations of \$100,000 or more at December 31, 2005 and 2004 are \$14,457,622 and \$13,198,775, respectively.

At December 31, 2005, the scheduled maturities of time deposits are as follows:

| | |
|------------|---------------|
| 2006 | \$ 27,731,397 |
| 2007 | 13,819,569 |
| 2008 | 6,876,653 |
| 2009 | 4,383,647 |
| 2010 | 2,343,570 |
| Thereafter | 700,932 |
| | \$ 55,855,768 |

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 has 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%. The current aggregate balances of these notes at December 31, 2005 and 2004 were \$14,333,333 and \$4,666,667, respectively. The loans are secured by a blanket agreement that includes all qualifying 1-4 family residential mortgage loans. As of December 31, 2005, the Bank held \$26,592,175 in qualifying mortgages.

Notes to Consolidated Financial Statements

The Bank also has two owner-financed unsecured notes originally totaling \$149,000. The terms call for monthly payments of \$1,053 and bear a fixed interest rate of 8.0%. The current balances at December 31, 2005 and 2004 were \$14,447 and \$35,410, respectively. The loans were for the purchase of 4.076 acres in Dinwiddie County, Virginia.

At December 31, 2005, the Bank had \$18,140,407 available under open lines of credit with other financial institutions and the FHLB.

The contractual maturities of borrowings for the year ended December 31, 2005 are as follows:

| | | |
|------------|----|----------------------|
| 2006 | \$ | 347,780 |
| 2007 | | 333,333 |
| 2008 | | 333,333 |
| 2009 | | 333,333 |
| 2010 | | 333,333 |
| Thereafter | | <u>12,666,668</u> |
| | | <u>\$ 14,347,780</u> |

Note 8. Income Taxes

Income tax expense for the years ended December 31, 2005, 2004 and 2003 consists of the following:

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|------------------------|-------------------|-------------------|-------------------|
| Current tax expense | \$ 684,359 | \$ 644,034 | \$ 667,659 |
| Deferred tax (benefit) | <u>(78,708)</u> | <u>(67,496)</u> | <u>(34,333)</u> |
| | <u>\$ 605,651</u> | <u>\$ 576,538</u> | <u>\$ 633,326</u> |

Income tax expense differs from the amounts computed by applying the U. S. Federal income tax rate of 34% in 2005, 2004 and 2003 to earnings before income taxes as a result of the following:

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---------------------------------|-------------------|-------------------|-------------------|
| Computed "expected" tax expense | \$ 655,826 | \$ 620,660 | \$ 657,480 |
| Tax-exempt interest | (5,892) | (5,564) | (15,965) |
| Bank-owned life insurance | (36,106) | (24,458) | (16,479) |
| Other, net | <u>(8,177)</u> | <u>(14,100)</u> | <u>8,290</u> |
| | <u>\$ 605,651</u> | <u>\$ 576,538</u> | <u>\$ 633,326</u> |

Notes to Consolidated Financial Statements

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2005 and 2004 are presented below:

| | 2005 | 2004 |
|-------------------------------------|-------------|-------------|
| Deferred Tax Assets | | |
| Net unrealized loss on securities | | |
| available for sale | \$ 333,192 | \$ 85,489 |
| Allowance for loan losses | 280,687 | 266,589 |
| Deferred compensation plans | 205,083 | 177,420 |
| Nonaccrual loan interest | 8,733 | 5,747 |
| Deferred tax assets | \$ 827,695 | \$ 535,245 |
| Deferred Tax Liabilities | | |
| Net gain on sale or exchange of | | |
| fixed assets | \$ -- | \$ 3,491 |
| Depreciation | 135,256 | 165,726 |
| Deferred tax liabilities | \$ 135,256 | \$ 169,217 |
| Net deferred tax assets | \$ 692,439 | \$ 366,028 |

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 2005, 2004 and 2003, 401(k) plan contributions totaled \$137,552, \$107,273 and \$135,186, respectively.

Note 10. Executive Supplemental Income Plans

A Deferred Compensation Income Plan 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 Plans 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 2005, 2004 and 2003 based on the present value of the retirement benefits amounted to \$77,360, \$58,751 and \$43,467, 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 \$2,921,786 and \$4,030,040 at December 31, 2005 and 2004, respectively. During 2005, total principal additions were \$2,000,950 and total principal payments were \$3,109,204. Total deposit relationships for related party persons and firms of \$2,951,744 were reported as of December 31, 2005.

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, 2005, the Bank could declare dividends of \$2,735,895 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, 2005 and 2004, the aggregate amounts of daily average required balances are approximately \$671,000 and \$566,000, 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, 2005 and 2004, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2005, 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, 2005: | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$17,314 | 16.9% | \$ 8,194 | 8.0% | \$10,242 | 10.0% |
| Tier 1 Capital (to Risk Weighted Assets) | \$16,429 | 16.0% | \$ 4,097 | 4.0% | \$ 6,145 | 6.0% |
| Tier 1 Capital (to Average Assets) | \$16,429 | 11.4% | \$ 5,783 | 4.0% | \$ 7,228 | 5.0% |
| As of December 31, 2004: | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$16,390 | 16.1% | \$ 8,067 | 8.0% | \$10,084 | 10.0% |
| Tier 1 Capital (to Risk Weighted Assets) | \$15,530 | 15.4% | \$ 4,033 | 4.0% | \$ 6,050 | 6.0% |
| Tier 1 Capital (to Average Assets) | \$15,530 | 11.7% | \$ 5,291 | 4.0% | \$ 6,614 | 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, 2005 and 2004, is as follows:

| | <u>2005</u> | <u>2004</u> |
|---|---------------|--------------|
| Financial instruments whose contract amounts represent credit risk: | | |
| Commitments to extend credit | \$ 10,998,124 | \$ 9,071,510 |
| Federal Home Loan Bank letter of credit to secure public deposits | 2,750,000 | 2,250,000 |
| Standby letters of credit | 896,334 | 518,082 |

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, 2005, deposits in excess of amounts insured by the Federal Deposit Insurance Corporation were \$4,282,187.

Note 17. Fair Value of Financial Instruments and Interest Rate Risk

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 reprice 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 carrying amounts of borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements. 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, 2005 and 2004, fair values of loan commitments and standby letters of credit were immaterial.

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

| | December 31, 2005 | | December 31, 2004 | |
|------------------------------------|--------------------------|-------------------|--------------------------|-------------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| | (in thousands) | | | |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 7,694 | \$ 7,694 | \$ 7,244 | \$ 7,244 |
| Interest bearing deposits in banks | 3,015 | 3,010 | -- | -- |
| Securities available-for-sale | 25,038 | 25,038 | 20,433 | 20,433 |
| Restricted investments | 1,265 | 1,265 | 807 | 807 |
| Loans, net | 93,294 | 92,092 | 92,708 | 92,725 |
| Accrued interest receivable | 638 | 638 | 523 | 523 |
| Financial liabilities: | | | | |
| Deposits | 110,663 | 110,342 | 111,070 | 111,293 |
| Borrowings | 14,348 | 14,381 | 4,702 | 4,700 |
| Accrued interest payable | 218 | 218 | 163 | 163 |

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 8. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

None

Item 8A. Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-KSB. Based on that evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as adopted by the Board of Governors of the Federal Reserve System, is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Item 8B. Other Information

None

Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act

All required information on the executive officers and directors of the Bank is incorporated herein by reference from the Bank's 2006 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 executive officer of the Bank who is not a director of the Bank:

| <u>Name (Age)</u> | <u>Principal Occupation Over Last Five Years</u> |
|----------------------------|--|
| James B. Neville, Jr. (42) | Executive Vice President & Chief Financial Officer |

Item 10. Executive Compensation

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

Item 11. 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 12. Certain Relationships and Related Transactions

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

Item 13. Exhibits

The following exhibits are filed as part of this Form 10-KSB 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 between Bank of McKenney and each of the following officers: James B. Neville, Jr., Ruth M. Wray, Lynda P. Cunningham, and Mark H. Stevens | *** |
| 21.1 | 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 Annual Report on Form 10-KSB for the year ended December 31, 2003, filed with the Board of Governors of the Federal Reserve System on March 29, 2004.

*** Incorporated herein 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.

† Filed herewith.

Item 14. Principal Accountant Fees and Services

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

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BANK OF MCKENNEY

Date: March 14th, 2006

By: _____
Richard M. Liles
President and Chief Executive Officer

In accordance with the Exchange Act, this report has been signed by the following persons on behalf of the registrant and in their capacities and on the dates indicated.

| <u>Signature</u> | <u>Capacity</u> | <u>Date</u> |
|--------------------------------|--|-------------------------------|
| _____ Richard M. Liles | President and Chief Executive Officer (principal executive officer) | March 14 th , 2006 |
| _____ James B. Neville, Jr. | Executive Vice President and Chief Financial Officer (principal financial officer) | March 14 th , 2006 |
| _____ W.D. Allen, III | Director | March 14 th , 2006 |
| _____ Harry D. Baird, III | Director | March 14 th , 2006 |
| _____ L.M. Harrison, Jr. | Director | March 14 th , 2006 |
| _____ Rudy L. Hawkins | Director | March 14 th , 2006 |
| _____ Joseph W. Lyle | Director | March 14 th , 2006 |
| _____ Edward B. Titmus | Director | March 14 th , 2006 |

CERTIFICATIONS

I, Richard M. Liles, certify that:

1. I have reviewed this annual report on Form 10-KSB 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 small business issuer of, and for, the periods presented in this report;
4. The small business issuer'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 small business issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (c) disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Richard M. Liles
President and Chief Executive Officer

Date: March 14th, 2006

CERTIFICATIONS

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

1. I have reviewed this annual report on Form 10-KSB 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 small business issuer of, and for, the periods presented in this report;
4. The small business issuer'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 small business issuer and have:
 - (b) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (c) disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

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

Date: March 14th, 2006

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-KSB for the period ending December 31, 2005 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.

Richard M. Liles
President and Chief Executive Officer

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

Dated: March 14th, 2006