

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

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2009

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT OF 1934**

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

**BANK OF MCKENNEY**

(Exact name of registrant as specified in its charter)

**Virginia**

**54-0132540**

(State or other jurisdiction of incorporation or organization)

(IRS employer identification no.)

**20718 First Street**

**McKenney, Virginia**

**23872**

(Address of principal executive offices)

(Zip Code)

**(804) 478-4434**

(Registrant's telephone number, including area code)

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

Yes  No

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

Large accelerated filer

Accelerated Filer

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

Smaller reporting company

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

Yes  No

SEC 1296 (02-08) **Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practical date.

**1,926,656 shares of Common Stock, par value \$2.00 per share (November 12, 2009)**

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****BANK OF MCKENNEY AND SUBSIDIARY****Consolidated Balance Sheets**

September 30, 2009 (unaudited) and December 31, 2008

<b>ASSETS</b>	September 30, 2009	December 31, 2008
Cash and due from banks	\$ 6,523,004	\$ 6,847,451
Federal funds sold	3,126,000	858,000
Interest-bearing time balances in other banks	2,000,000	1,540,252
Securities available for sale, at fair market value	28,877,800	28,998,239
Securities available for sale, at fair market value	3,931,527	956,448
Restricted investments	794,725	789,525
Loans:		
Commercial	7,639,203	7,922,920
Commercial Real Estate	51,565,879	48,625,651
Real Estate Construction	12,455,684	9,833,256
Residential Real Estate	46,810,670	43,046,066
Consumer	2,386,745	2,355,887
Loans, gross	\$ 120,858,181	\$ 111,783,780
Less allowance for loan losses	(2,043,210)	(1,135,000)
Loans, net	\$ 118,814,971	\$ 110,648,780
Land, premises and equipment, net	7,999,546	8,185,167
Other real estate owned	495,206	--
Accrued interest receivable	833,514	897,883
Bank owned life insurance	3,224,517	3,127,712
Other assets	2,629,092	2,612,367
<b>Total Assets</b>	<b>\$ 179,249,902</b>	<b>\$ 165,461,824</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing deposits	\$ 25,840,824	\$ 26,141,215
Savings and interest bearing demand deposits	35,562,476	34,959,275
Time deposits	94,354,346	81,792,333
Total deposits	\$ 155,757,646	\$ 142,892,823
Federal Home Loan Bank advances	3,083,333	3,333,333
Accrued interest payable	324,052	324,396
Accrued expenses and other liabilities	1,284,922	1,543,650
Total Liabilities	\$ 160,449,953	\$ 148,094,202
Commitments and contingencies	\$ --	\$ --
<b>SHAREHOLDERS' EQUITY</b>		
Common stock, \$2 par value, authorized 2,250,000 shares issued and outstanding 1,926,656 shares	\$ 3,853,312	\$ 3,853,312
Surplus	5,893,958	5,893,958
Retained earnings	9,094,420	8,972,226
Accumulated other comprehensive loss	(41,741)	(1,351,874)
Total shareholders' equity	\$ 18,799,949	\$ 17,367,622
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 179,249,902</b>	<b>\$ 165,461,824</b>

See Notes to Unaudited Consolidated Financial Statements

**BANK OF MCKENNEY AND SUBSIDIARY**

**Consolidated Statements of Income**

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2009	2008	2009	2008
<b>Interest and Dividend Income:</b>				
Interest and fees on loans	\$ 2,044,956	\$ 2,098,105	\$ 6,056,149	\$ 6,280,757
Interest and dividends on securities - taxable	332,157	373,570	1,095,452	1,023,261
Interest on securities - nontaxable	60,295	38,917	140,968	111,698
Interest on federal funds sold	2,710	5,535	5,413	91,436
Interest on deposits with other institutions	2,377	27,386	7,541	57,661
Total interest and dividend income	<u>\$ 2,442,495</u>	<u>\$ 2,543,513</u>	<u>\$ 7,305,523</u>	<u>\$ 7,564,813</u>
<b>Interest Expense:</b>				
Money market and NOW accounts	\$ 52,958	\$ 81,751	\$ 164,932	\$ 200,366
Savings	14,754	17,149	43,259	53,044
Time	640,722	769,684	1,959,223	2,425,172
Federal funds purchased	5	3,728	114	3,728
Federal Home Loan Bank advances	37,810	88,980	115,164	403,585
Total interest expense	<u>\$ 746,249</u>	<u>\$ 961,292</u>	<u>\$ 2,282,692</u>	<u>\$ 3,085,895</u>
Net interest income	\$ 1,696,246	\$ 1,582,221	\$ 5,022,831	\$ 4,478,918
Provision for loan losses	1,150,000	50,000	1,473,000	210,000
Net interest income after provision for loan losses	<u>\$ 546,246</u>	<u>\$ 1,532,221</u>	<u>\$ 3,549,831</u>	<u>\$ 4,268,918</u>
<b>Noninterest income:</b>				
Service charges on deposit accounts	\$ 219,654	\$ 217,723	\$ 656,027	\$ 639,104
Secondary market origination fees	190,555	112,707	417,264	342,381
Net gain/(loss) on sale of securities	30,055	(234)	69,791	250,238
Bank-owned Life Insurance	31,496	32,275	96,805	94,705
Other operating income	64,695	56,473	194,328	159,916
Gain on sale of other real estate owned	--	--	--	9,579
Total noninterest income	<u>\$ 536,455</u>	<u>\$ 418,944</u>	<u>\$ 1,434,215</u>	<u>\$ 1,495,923</u>
<b>Noninterest expense:</b>				
Salaries and employee benefits	\$ 1,004,146	\$ 911,067	\$ 2,867,004	\$ 2,727,016
Occupancy expense	100,189	95,177	305,851	279,041
Furniture and equipment expense	116,652	129,828	352,875	359,022
Data processing	55,193	60,197	148,090	164,317
Telecommunications	37,952	36,783	112,724	106,066
Stationery and supplies	25,185	19,563	77,665	65,665
Audit and accounting fees	44,910	44,984	137,952	136,724
Legal and professional fees	69,878	3,582	83,574	10,202
FDIC assessment fees	56,126	22,365	181,517	41,836
Corporate franchise tax	30,153	30,876	90,461	92,626
Other operating expenses	219,864	164,136	564,900	496,789
Total noninterest expense	<u>\$ 1,760,248</u>	<u>\$ 1,518,558</u>	<u>\$ 4,922,613</u>	<u>\$ 4,479,304</u>
Net income (loss) before taxes	\$ (677,547)	\$ 432,607	\$ 61,433	\$ 1,285,537
Income taxes	(260,197)	128,032	(60,761)	367,062
<b>Net income (loss)</b>	<u>\$ (417,350)</u>	<u>\$ 304,575</u>	<u>\$ 122,194</u>	<u>\$ 918,475</u>
Net income (loss) per common share, basic and diluted	<u>\$ (0.22)</u>	<u>\$ 0.16</u>	<u>\$ 0.06</u>	<u>\$ 0.48</u>

See Notes to Unaudited Consolidated Financial Statements

**BANK OF MCKENNEY AND SUBSIDIARY**  
**Consolidated Statements of Changes in Shareholders' Equity**  
For the Nine Months Ended September 30, 2009 and 2008  
(unaudited)

	<u>Common Stock</u>	<u>Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Comprehensive Income</u>	<u>Total</u>
<b>Balance at December 31, 2007</b>	\$ 3,853,312	\$ 5,893,958	\$ 8,240,118	\$ 81,313		\$ 18,068,701
Comprehensive loss:						
Net income	-	-	918,475	-	\$ 918,475	918,475
Other comprehensive loss:						
Unrealized holding losses on securities available for sale arising during the period, net of tax benefit of \$616,001	-	-	-	-	(1,195,767)	-
Less reclassification adjustment, net of tax of (\$85,080)	-	-	-	-	(165,158)	-
Other comprehensive loss, net of tax				(1,360,925)	\$ (1,360,925)	(1,360,925)
Total comprehensive loss					<u>\$ (442,450)</u>	
<b>Balance at September 30, 2008</b>	<u>\$ 3,853,312</u>	<u>\$ 5,893,958</u>	<u>\$ 9,158,593</u>	<u>\$ (1,279,612)</u>		<u>\$ 17,626,251</u>
<b>Balance at December 31, 2008</b>	\$ 3,853,312	\$ 5,893,958	\$ 8,972,226	\$ (1,351,874)		\$ 17,367,622
Comprehensive income:						
Net income	-	-	122,194	-	\$ 122,194	122,194
Other comprehensive income:						
Unrealized holding gains on securities available for sale arising during the period, net of tax of \$698,646	-	-	-	-	1,356,195	-
Less reclassification adjustment, net of tax of (\$23,729)	-	-	-	-	(46,062)	-
Other comprehensive income, net of tax				1,310,133	\$ 1,310,133	1,310,133
Total comprehensive income					<u>\$ 1,432,327</u>	
<b>Balance at September 30, 2009</b>	<u>\$ 3,853,312</u>	<u>\$ 5,893,958</u>	<u>\$ 9,094,420</u>	<u>\$ (41,741)</u>		<u>\$ 18,799,949</u>

See Notes to Unaudited Consolidated Financial Statements

**BANK OF MCKENNEY AND SUBSIDIARY**  
**Consolidated Statements of Cash Flows**  
For the Nine Months Ended September 30, 2009 and 2008  
(unaudited)

	2009	2008
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 122,194	\$ 918,475
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	374,413	375,630
Provision for loan losses	1,473,000	210,000
Capitalized interest on interest-bearing deposits in banks	--	(26,667)
Increase in cash surrender value of life insurance	(96,805)	(94,704)
Net gain on sales of securities available for sale	(69,791)	(250,239)
Net gain on sales of other real estate owned	--	(9,579)
Net amortization of premium on securities	(29,452)	(58,369)
Changes in assets and liabilities:		
(Increase) Decrease in accrued interest receivable	64,369	(143,912)
Increase in other assets	(691,642)	(109,501)
Decrease in accrued interest payable	(344)	(63,430)
Increase in accrued expenses and other liabilities	261,469	125,627
Net cash provided by operating activities	\$ 1,407,411	\$ 873,331
<b>Cash flows from Investing Activities</b>		
Net change in interest-bearing deposits in banks	\$ (459,748)	\$ (1,500,000)
Activity in available for sale securities:		
Sales	3,569,365	7,227,306
Maturities, prepayments and calls	6,632,002	15,834,587
Purchases	(10,971,714)	(26,151,862)
(Purchase) Redemption of restricted securities (FHLB stock)	(5,200)	299,500
Net increase in loans	(10,137,855)	(5,663,686)
Purchase of land, premises and equipment	(185,334)	(280,265)
Proceeds from sale of other real estate owned	--	144,579
Net cash used in investing activities	\$ (11,558,484)	\$ (10,089,841)
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	\$ 12,864,823	\$ 11,324,396
Dividend distributions	(520,197)	(520,197)
Repayment of long-term debt	(250,000)	(6,250,001)
Net cash provided by financing activities	\$ 12,094,626	\$ 4,554,198
Net increase (decrease) in cash and cash equivalents	\$ 1,943,553	\$ (4,662,312)
<b>Cash and Cash Equivalents</b>		
Beginning of year	7,705,451	11,223,898
End of Year	\$ 9,649,004	\$ 6,561,586
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash paid during the year for:		
Interest	\$ 2,282,347	\$ 3,149,325
Income Taxes	\$ 396,836	\$ 391,800
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Fair value adjustment for securities	\$ 1,985,050	\$ (2,062,006)
Transfer between loans and other real estate owned	\$ 498,664	\$ 334,478

See Notes to Unaudited Consolidated Financial Statements

# Notes to Unaudited Consolidated Financial Statements

## 1. General

Bank of McKenney (the “Bank”) offers a full range of banking and financial services to individuals, professionals, and small and medium sized businesses through six full service banking offices in the counties of Dinwiddie, southern Chesterfield and Prince George and the city of Colonial Heights. 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, L.L.C. (the “Subsidiary”) is a wholly-owned subsidiary of the Bank. McKenney Group, L.L.C. was formed in December of 2000 to provide networking solutions to Virginia community banks. The Subsidiary maintains the partial ownership interests previously acquired by McKenney Title, Inc.

The accompanying consolidated financial statements of Bank of McKenney and its subsidiary collectively have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. They do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. Therefore, these consolidated statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Bank of McKenney Annual Report on Form 10-K for the year ended December 31, 2008. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying consolidated financial statements contain all adjustments and reclassifications consistent with a normal and recurring nature considered necessary to present fairly the financial position as of September 30, 2009 and December 31, 2008 and the results of operations for the three and nine month periods ended September 30, 2009 and 2008 and changes in shareholders’ equity and cash flows for the nine months ended September 30, 2009 and 2008. Operating results for the three and nine-month periods ended September 30, 2009 and 2008 are not necessarily indicative of full year financial results.

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

## 2. Investment Securities

The following table sets forth a summary of the amortized cost and fair market value of investment securities available for sale at September 30, 2009 and December 31, 2008:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Market Value</u>
<b>September 30, 2009</b>				
<b>Available for sale</b>				
U.S. government agencies	\$ 11,588,235	\$ 60,382	\$ (22,317)	\$ 11,626,300
Obligations of state and political subdivisions	8,347,637	356,266	(1,205)	8,702,698
Corporate debt securities	9,005,173	164,149	(620,520)	8,548,802
	<u>\$ 28,941,045</u>	<u>\$ 580,797</u>	<u>\$ (644,042)</u>	<u>\$ 28,877,800</u>
<b>Held to maturity</b>				
Corporate securities	<u>\$3,931,527</u>	<u>\$ 336,648</u>	<u>\$ --</u>	<u>\$ 4,268,175</u>
<b>December 31, 2008</b>				
<b>Available for sale</b>				
U.S. government agencies	\$ 12,200,503	\$ 195,850	\$ -	\$ 12,396,353
Mortgage-backed securities	1,199,432	26,125	-	1,225,557
Obligations of state and political subdivisions	4,234,377	27,213	(58,438)	4,203,152
Corporate debt securities	13,412,221	69,250	(2,308,294)	11,173,177
	<u>\$ 31,046,533</u>	<u>\$ 318,438</u>	<u>\$ (2,366,732)</u>	<u>\$ 28,998,239</u>
<b>Held to maturity</b>				
Corporate securities	<u>\$ 956,448</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 956,448</u>

The contractual maturities of investment securities classified as available for sale on September 30, 2009 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.

	<b>Available for sale</b>		<b>Held to maturity</b>	
	<u>Amortized Cost</u>	<u>Fair Market Value</u>	<u>Amortized Cost</u>	<u>Fair Market Value</u>
<b>Available for Sale</b>				
Maturing within one year	\$ 2,120,536	\$ 2,132,146	\$ -	\$ -
Maturing after one year, but within five years	12,003,562	11,946,367	3,931,527	4,268,175
Maturing after five years, but within ten years	7,381,659	7,221,076	-	-
Maturing after ten years	7,435,288	7,578,211	-	-
	<u>\$ 28,941,045</u>	<u>\$ 28,877,800</u>	<u>\$ 3,931,527</u>	<u>\$ 4,268,175</u>

Due to volatility in the prices of certain debt securities, future investments in non-government issued investment grade debt will likely be categorized as HTM and carried at amortized cost until maturity. The Bank has the ability and intent to hold all purchases to maturity; however, AFS has historically been chosen to provide for maximum liquidity. The Bank has numerous other means of liquidity and foresees no concern over this election during this low point in the economy. As of September 30, 2009, three issues had been so classified. One issue was so classified as HTM on December 31, 2008.

There were no securities pledged to secure public deposits or for other purposes required by law at September 30, 2009. The Bank utilizes letters of credit through the Federal Home Loan Bank for meeting the collateral requirements of such deposits.

Due to certain banking relationships with the Federal Reserve Bank, the Federal Home Loan Bank and Community Bankers' Bank, the Bank has invested \$794,725 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 September 30, 2009 and December 31, 2008 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. All issues with unrealized losses are within the available for sale segment of the portfolio, and a summary of these securities as of September 30, 2009 and December 31, 2008 is as follows:

Description	September 30, 2009					
	Total		Less than 12 Months		12 Months or Greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Available for sale</b>						
Government agencies	\$ 3,030,300	\$ (22,317)	\$ 3,030,300	\$ (22,317)	\$ -	\$ -
Corporate debt securities	\$ 3,745,350	\$ (620,520)	\$ -	\$ -	\$ 3,745,350	\$ (620,520)
Tax exempt municipals	387,900	(1,205)	-	-	387,900	(1,205)
Unrealized Loss Positions	<u>\$ 7,163,550</u>	<u>\$ (644,042)</u>	<u>\$ 3,030,300</u>	<u>\$ (22,317)</u>	<u>\$ 4,133,250</u>	<u>\$ (621,725)</u>
Description	December 31, 2008					
	Total		Less than 12 Months		12 Months or Greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Available for sale</b>						
Corporate debt securities	\$ 7,650,677	\$ (2,308,294)	\$ 7,650,677	\$ (2,308,294)	\$ -	\$ -
Tax exempt municipals	1,864,924	(58,438)	1,456,136	(49,577)	408,788	(8,861)
Unrealized Loss Positions	<u>\$ 9,515,601</u>	<u>\$ (2,366,732)</u>	<u>\$ 9,106,813</u>	<u>\$ (2,357,871)</u>	<u>\$ 408,788</u>	<u>\$ (8,861)</u>

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.

The securities identified above for September 30, 2009 with unrealized losses consist of three corporate issues, one government agency issue, and two issues of separate municipalities. All of the corporate issues are investment grade; however, the current economic melt-down has caused debt prices to widen to unusually high levels. Because of this yield spread, management invested in quality companies with strong ratings to improve margins. While this choice has adversely affected unrealized losses, management believes all unrealized losses reflect changes in the national and global environment that has generated hysteria in the markets of many countries. No principal is expected to be lost, and the unrealized losses, primarily due to market turbulence, are considered temporary in nature. Management will continuously monitor these issues to ensure credit worthiness persists and ratings remain strong.

The Corporation's investment in Federal Home loan Bank ("FHLB") stock totaled \$447,900 at September 30, 2009. FHLB stock is generally viewed as a long term investment and as a restricted investment security which is carried at cost, because there is no market for the stock other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on ultimate recoverability of the par value rather than by recognizing temporary declines in value. Despite the FHLB's reduced dividend payouts and temporary suspension of repurchases of excess capital stock in 2009, the Bank does not consider this investment to be other than temporarily impaired at September 30, 2009 and no impairment has been recognized.

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

### 3. Allowance for Loan Losses

The following represents an analysis of changes in the allowance for loan losses for the nine months ended September 30, 2009 and 2008:

	September 30,	
	2009	2008
Balance, beginning of period	\$ 1,135,000	\$ 925,000
Provision for loan losses	1,473,000	210,000
Charge-offs	(575,085)	(154,113)
Recoveries of loans previously charged off	10,295	34,127
Balance, end of period	<u>\$ 2,043,210</u>	<u>\$ 1,015,014</u>
Allowance for loan losses to total loans	<u>1.69%</u>	<u>0.90%</u>

The following is a summary of information pertaining to impaired loans at September 30, 2009 and December 31, 2008:

	September 30, 2009	December 31, 2008
Impaired loans with a valuation allowance	\$ 2,770,746	\$ 1,570,055
Impaired loans without a valuation allowance	1,393,649	193,028
Other real estate owned	495,206	--
Total impaired loans	<u>\$ 4,659,601</u>	<u>\$ 1,763,083</u>
Valuation allowance related to impaired loans	<u>\$ 587,500</u>	<u>\$ 409,500</u>
Average investment in impaired loans	<u>\$ 3,955,976</u>	<u>\$ 1,448,309</u>
Interest income recognized	<u>\$ 218,394</u>	<u>\$ 108,988</u>

There were no non-accrual loans excluded from impaired loan disclosure at September 30, 2009 and December 31, 2008. At both September 30, 2009 and December 31, 2008 there were no loans past due in excess of ninety days and still accruing recorded.

### 4. Earnings Per Share

As the Bank does not currently offer stock options, there was no effect on income available to common shareholders. The following shows the weighted average number of shares used in computing earnings per share.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009		2008		2009		2008	
	Shares	Per Share	Shares	Per Share	Shares	Per Share	Shares	Per Share
Basic & Diluted earnings (loss) per share	<u>1,926,656</u>	<u>\$ (0.22)</u>	<u>1,926,656</u>	<u>\$ 0.16</u>	<u>1,926,656</u>	<u>\$ 0.06</u>	<u>1,926,656</u>	<u>\$ 0.48</u>

## 5. Fair Value Measurements

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

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

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

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

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

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

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

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

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

*Off-balance-sheet instruments:* The fair value of commitments to extend credit is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present credit worthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2009 and December 31, 2008, fair values of loan commitments and standby letters of credit were immaterial; therefore, they have not been included in the table below.

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

	<u>September 30, 2009</u>		<u>December 31, 2008</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
	(in thousands)			
Financial assets:				
Cash and cash equivalents	\$ 9,649	\$ 9,649	\$ 7,705	\$ 7,705
Interest bearing deposits in banks	2,000	2,005	1,540	1,540
Securities available-for-sale	28,877	28,877	28,998	28,998
Securities held-to-maturity	3,932	4,265	956	956
Restricted investments	795	795	790	790
Loans, net	118,815	123,002	110,649	119,119
Accrued interest receivable	834	834	898	898
Financial liabilities:				
Deposits	\$ 155,758	\$ 156,850	\$ 142,893	\$ 143,641
Borrowings	3,083	3,088	3,333	3,340
Accrued interest payable	324	324	324	324

Generally accepted accounting principles ("GAAP") specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Bank's market assumptions. The three levels of the fair value hierarchy based on these two types of inputs are as follows:

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

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

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

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

Recurring basis:

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

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2009:

<u>Description</u>	<u>Balance as of September 30, 2009</u>	<u>Fair Value Measurements at September 30, 2009 Using</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Assets:				
Available-for-sale securities	\$ 28,877,800	\$ -	\$ 28,877,800	\$ -

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

Non-recurring basis:

*Impaired Loans:* Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

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

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

<b>Description</b>	<b>Carrying value at September 30, 2009</b>			
	<b>Balance as of September 30, 2009</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Assets:				
Impaired Loans	\$ 2,183,246	\$ -	\$ 2,183,246	\$ -
Other Real Estate Owned	\$ 495,206	\$ -	\$ 495,206	\$ -

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.

## 6. Subsequent Events

The Bank has evaluated subsequent events for potential recognition and / or disclosure through November 13, 2009, the date the financial statements included in this Quarterly Report on Form 10-Q were issued. The Bank has filed with the Board of Governors of the Federal Reserve a Schedule 13e-3 to delist and return to a private company status through the creation of a preferred class of stock and subsequent reclassification into this newly created class all shareholders owning 450 or fewer certificated shares in a cashless transaction. Recommendations to amend and restate the Articles of Incorporation, create a class of preferred stock, effect the reclassification as specified above and adjourn the meeting are currently detailed in a Proxy Statement and mailed to the shareholders of record as of October 19, 2009. The Board is currently soliciting proxy votes, and a special meeting to vote on these recommendations is set for 2:00 p.m. on December 8, 2009.

## **Item 2. Management’s Discussion and Analysis or Plan of Operation**

*The following discussion is intended to assist readers in understanding and evaluating the Bank’s financial condition and results of operations. In conjunction with reviewing the following discussion, you should also read and review the unaudited September 2009 and 2008 financial statements and accompanying notes presented previously in this document. This analysis provides an overview of the significant changes that occurred during the periods presented.*

*This report may contain, in addition to historical information, various “forward looking statements” that represent our judgment concerning the future and are subject to risks and uncertainties that could cause our actual operating results and financial position to differ materially from those projected in the forward looking statements. These forward looking statements can be identified by the use of forward looking terminology, such as “may,” “will,” “expect,” “anticipate,” “estimate” or “continue” or comparable words. We caution that any such forward looking statements are further qualified by important factors that could cause our actual operating results and financial position to differ materially from the forward looking statements, including, without limitation, considerations described in connection with specific forward looking statements and other cautionary statements set forth in this report.*

### **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.

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 normally does not separately identify such 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.

### **Comparison of Financial Condition at September 30, 2009 and December 31, 2008**

At the end of the third quarter, total assets were \$179.2 million, representing a \$13.7 million or 8.28% increase over the December 31, 2008 level of \$165.5 million. Total deposits amounted to \$155.8 million as of September 30, 2009, which represents a \$12.9 million or 9.03% increase from the \$142.9 million level as of December 31, 2008. On an annualized basis, deposits grew during the third quarter at a rate of 12.04%. During the same period, total loans expanded by 8.14% or \$9.1 million to the September 30, 2009 balance of \$120.9 million. Loans, on an annualized basis, grew at a rate of 10.85%. At September 30, 2009, the investment portfolio, including time deposits in other banks, was \$35.6 million, a 10.22% increase in comparison to the December 31, 2008 \$32.3 million level. Overnight federal funds sold ramped up on growth to a September 30, 2009 level of \$3.1 million, a 244.44% increase over the \$0.9 million level reported on December 31, 2008. Cumulatively, earning assets grew \$14.6 million for the first three quarters or 13.43% on an annualized basis and represent 89.06% of total assets.

The allowance for loan losses was \$2,043,000 as of September 30, 2009, or 1.69% of loans outstanding, compared to \$1,135,000 as of December 31, 2008 or 1.02% of outstanding loans. Charges to the reserve account for loan losses amounted to \$575,000 as of September 30, 2009 or 0.50% of average outstanding loans for 2009. For the first nine months of 2008, charges to the reserve of \$154,000 were taken representing 0.14% of average loans outstanding for the period. Allocations to the reserve account of \$1,473,000 were provisioned for the nine months of 2009 compared to provision allocations of \$210,000 for the same period of 2008.

The Bank continues to focus on delinquencies and nonperforming loans within the portfolio; however, delinquency and nonperforming ratios have risen to 0.71% or \$862,000 and 3.85% or \$4,659,000, respectively. These ratios, at December 31, 2008, stood at 0.61% or \$683,000 and 1.58% or \$1,763,000, respectively. While current economic conditions have resulted in increases in these categories, management continues to feel comfortable that losses will be minimized by collateral positions as well as the Bank's ability and willingness to work with the borrowers during the current cycle where possible. Nevertheless, certain credits had deteriorated during the third quarter to levels where the full collectability of said debts became questionable if not doubtful. Management felt it prudent to charge the credits off, or down by impaired amounts, and to increase loan reserves to a greater percentage of loans outstanding. After these additional allocations to reserves, the allowance for loan losses stands at 1.69% of total loans, an increase of 67 basis points over that of December 31, 2008.

## **Comparison of Results of Operations for the Nine months Ended September 30, 2009 and 2008**

For the nine-month period ended September 30, 2009, the Bank reported earnings of \$122,000, a decrease of 86.71% when compared to \$918,000 through the first nine months of 2008. The reduced earnings are largely the result of provision charges to increase reserves. For the first three quarters of 2009 and 2008, earnings per basic and diluted share of \$0.06 and \$0.48, respectively, were recorded. Annualized returns on average assets and average equity for the first nine months of 2009 were 0.10% and 0.91%, respectively, compared to 0.74% and 6.63%, respectively, for the same period in 2008.

*Net interest income.* For the first nine months of 2009, net interest income increased to \$5,023,000 from \$4,479,000 in the comparable period in 2008. Average loans through the third quarter of 2009, when compared to the same period in 2008, grew to \$116.0 million from \$109.3 million, an increase of 6.13%. The average investment portfolio declined from a 2008 nine-month average balance of \$32.0 million to a \$30.5 million average through the third quarter of 2009, or a decrease of 4.69%. Average deposit growth through the nine months of 2009 has increased 11.74% or \$12.9 million to \$122.8 million over the same prior year period's average of \$109.9 million. The Bank's prime based loan portfolio yields decreased 69 basis points when comparing the first nine months of 2009 to that period in 2008 while the investment portfolio in the same periods gained 72 basis points. Cumulatively, yields on earning assets decreased 32 basis points from a 2008 nine-month average of 6.86% to an average of 6.54% for the current year's same period. The cost of funds has plummeted for the nine months ended September 30, 2009 as a result of the current and prolonged low rate environment to a level of 2.42% or 97 basis points below the 3.39% level reported for the same period in 2008. With the cost of funds declining at a faster pace than earning assets, the net interest margin has expanded by 44 basis points to 4.52%.

*Noninterest income.* Noninterest income, exclusive of securities transactions, rose 9.47% or \$118,000 during the first nine months of 2009 to \$1,364,000 when compared to \$1,246,000 for the same period in 2008. Service charges posted higher results with a \$17,000 or 2.66% increase when comparing the first nine months of 2009 to that of 2008. In comparing these same two periods, the mortgage originations department climbed \$88,000 or 25.73%. Other noninterest income increased by \$13,000 from the level recorded through the third quarter on 2008.

*Noninterest expense.* Noninterest expense increased \$444,000 or 9.91% to \$4,923,000 during the first three quarters of 2009 from \$4,479,000 for the same period in 2008. Separately within this category, salaries and benefits rose 5.13% or \$140,000 while occupancy and furniture & equipment expenses increased \$20,000 or 3.13%. Other operating expenses through September 30, 2009 grew \$284,000 or 25.49% to a level of \$1,398,000, primarily a result of FDIC increases and legal expenses associated with the pending proposal to return to a private company status.

*Provision for loan losses.* Provisions for loan losses amounted to \$1,473,000 through September 30, 2009 to offset a rise in the level of nonperforming/impaired assets, charges taken in 2009 to the reserve and general growth in the portfolio. During the same period in 2008, \$210,000 was allocated in provisions to the reserve for loan losses.

## **Comparison of Results of Operations for the Three Months Ended September 30, 2009 and 2008**

For the third quarter of 2009, the Bank posted a net loss of \$417,000 due primarily to a \$1.2 million provision charge to bolster the reserve for loan losses. This compares to 2008 third quarter earnings of \$305,000. A basic and diluted loss per share of \$0.22 was reported for the three months ended September 30, 2009, compared to basic and diluted earnings per share of \$0.16 for the prior year's results for the same period.

*Net interest income.* Net interest income increased 7.21% to \$1,696,000 in the third quarter of 2009 from \$1,582,000 in the comparable period in 2008. Margins have significantly expanded during the last few quarters as the cost of funds for deposits has plummeted 97 basis points while yields on earning assets have only dropped 32 basis points. This margin strength has offset much of the additional overhead costs mentioned above.

*Noninterest income.* Noninterest income, exclusive of securities transactions, grew 20.76% or \$87,000 in the third quarter of 2009 to \$506,000 when compared to \$419,000 for the same period in 2008. Service charges posted slightly higher results with a \$2,000 or 0.92% increase when comparing the third quarter of 2009 to the third quarter of 2008. The mortgage originations department experienced tremendous success reporting income for the 2009 third quarter of \$191,000. This represents a \$78,000 or 69.03% increase in revenues during the period when compared to the third quarter of 2008. Other noninterest products and services, including those of the insurance and investment departments, increased to \$96,000 for the third quarter of 2009, \$7,000 above the \$89,000 level recorded in the third quarter of 2008.

*Noninterest expense.* Noninterest expense increased \$241,000 or 15.87% to \$1,760,000 during the third quarter 2009 from \$1,519,000 for the same period in 2008. Salaries and benefits rose 10.21% or \$93,000 while occupancy and furniture & equipment expenses decreased \$8,000 or 3.56%. Other operating expenses for the third quarter of 2009 grew \$156,000 or 40.73% to a level of \$539,000 due primarily to substantially higher FDIC assessments coupled with legal and professional fees incurred in conjunction with a proposal to the shareholders to return to a private status at a special meeting to be held in December.

*Provision for loan losses.* Provision for loan losses increased from \$50,000 in the third quarter of 2008 to \$1,150,000 in the same period in 2009. This increase is to offset a rise in the level of nonperforming/impaired assets, charges taken in 2009 to the reserve and general growth in the portfolio.

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 September 30,					
	2009			2008		
	Average Balance	Income / Expense	Yield / <sup>(4)</sup> Rate	Average Balance	Income / Expense	Yield / <sup>(4)</sup> Rate
(Dollars in Thousands)						
Assets:						
Interest earning assets:						
Investment securities <sup>(1)</sup>	\$ 30,544	\$ 1,297	5.66%	\$ 31,999	\$ 1,185	4.94%
Interest-bearing balances with banks	334	8	3.20%	1,847	58	4.19%
Loans	115,966	6,056	6.98%	109,316	6,281	7.67%
Federal funds sold	3,592	6	0.22%	5,091	91	2.39%
Total interest earning assets	<u>150,436</u>	<u>7,367</u>	<u>6.54%</u>	<u>148,253</u>	<u>7,615</u>	<u>6.86%</u>
Non-interest earning assets:						
Cash and due from banks	7,129			4,503		
Premises and equipment	8,091			8,305		
Other assets	6,828			5,840		
Less: Allowance for loan losses	<u>(1,363)</u>			<u>(970)</u>		
	<u>20,685</u>			<u>17,678</u>		
	<u>\$ 171,121</u>			<u>\$ 165,931</u>		
Liabilities and Stockholders' Equity						
Interest bearing liabilities:						
Interest-bearing demand deposits	\$ 16,688	\$ 109	0.87%	\$ 14,251	\$ 136	1.28%
Money market deposit accounts	7,943	56	0.94%	7,013	64	1.22%
Savings accounts	11,595	43	0.50%	11,833	53	0.60%
Time deposits	86,576	1,959	3.02%	76,765	2,425	4.22%
Total interest-bearing deposits	<u>122,802</u>	<u>2,167</u>	<u>2.36%</u>	<u>109,862</u>	<u>2,678</u>	<u>3.26%</u>
Securities sold under repurchase agreements	24	0	0.56%	182	4	2.94%
Other borrowings	-	0	0.00%	-	0	0.00%
Total interest-bearing liabilities	<u>126,041</u>	<u>2,282</u>	<u>2.42%</u>	<u>121,448</u>	<u>3,086</u>	<u>3.39%</u>
Non-interest bearing liabilities:						
Demand deposits	25,568			24,459		
Other liabilities	1,524			1,541		
Total liabilities	<u>153,133</u>			<u>147,448</u>		
Shareholders' Equity	<u>17,988</u>			<u>18,483</u>		
Total Liabilities & Shareholders' Equity	<u>\$ 171,121</u>			<u>\$ 165,931</u>		
Interest Spread <sup>(2)</sup>			4.12%			3.47%
Net Interest Margin <sup>(3)</sup>		<u>\$ 5,085</u>	4.52%		<u>\$ 4,529</u>	4.08%

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

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

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

<sup>(4)</sup> Yields and rates are annualized.

## Liquidity and Capital

The liquidity ratio at September 30, 2009 rose to 28.63% compared to 27.35% reported as of December 31, 2008. 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 Federal Home Loan Bank of Atlanta. 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 Bank's capital ratios exceed regulatory requirements. The following table presents these ratios for the periods ending September 30, 2009 and December 31, 2008:

<b>Risk Based Capital Analysis</b>			
	September 30, 2009	December 31, 2008	
(Dollars in Thousands)			
Tier 1 Capital:			
Common stock	\$ 3,853	\$ 3,853	
Capital surplus	5,894	5,894	
Retained earnings	9,053	7,621	
Reverse: Unrealized losses	41	1,351	
Total tier 1 capital	<u>18,841</u>	<u>18,719</u>	
Tier 2 Capital:			
Allowance for loan losses up to 1.25%	<u>1,741</u>	<u>1,135</u>	
Tier 3 Capital:			
Deductions for investments in banking and finance subsidiaries	<u>(200)</u>	<u>(180)</u>	
Total Risk Based Capital	<u>\$ 20,382</u>	<u>\$ 19,674</u>	
Risk weighted assets	<u>\$ 139,149</u>	<u>\$ 130,354</u>	
Quarterly average assets	<u>\$ 176,299</u>	<u>\$ 165,210</u>	
Capital Ratios:	September 30, 2009	December 31, 2008	Regulatory Minimum
Tier 1 risk based capital ratio	13.54%	14.36%	4.00%
Total risk based capital ratio	14.65%	15.09%	8.00%
Leverage ratio	10.69%	11.33%	4.00%

## Recent Accounting Pronouncements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), “Business Combinations” (SFAS 141(R)) (ASC 805 Business Combinations). The Standard significantly changed the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any non-controlling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity’s first year that begins after December 15, 2008. The Bank does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements, at this time.

In April 2009, the FASB issued FSP FAS 141(R)-1, “Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies” (ASC 805 Business Combinations). FSP FAS 141(R)-1 amends and clarifies SFAS 141(R) to address application issues on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. The FSP is effective for assets and liabilities arising from contingencies in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Bank does not expect the adoption of FSP FAS 141(R)-1 to have a material impact on its consolidated financial statements.

In April 2009, the FASB issued FSP FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (ASC 820 Fair Value Measurements and Disclosures). FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with SFAS 157 when the volume and level of activity for the asset or liability have significantly decreased. The FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly. FSP FAS 157-4 is effective for interim and annual periods ending after June 15, 2009, and shall be applied prospectively. Earlier adoption is permitted for periods ending after March 15, 2009. The Bank does not expect the adoption of FSP FAS 157-4 to have a material impact on its consolidated financial statements.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, “Interim Disclosures about Fair Value of Financial Instruments” (ASC 825 Financial Instruments and ASC 270 Interim Reporting). FSP FAS 107-1 and APB 28-1 amends SFAS No. 107, “Disclosures about Fair Value of Financial Instruments,” to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. In addition, the FSP amends APB Opinion No. 28, “Interim Financial Reporting,” to require those disclosures in summarized financial information at interim reporting periods. The FSP is effective for interim periods ending after June 15, 2009, with earlier adoption permitted for periods ending after March 15, 2009. The Bank does not expect the adoption of FSP FAS 107-1 and APB 28-1 to have a material impact on its consolidated financial statements.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, “Recognition and Presentation of Other-Than-Temporary Impairments” (ASC 320 Investments – Debt and Equity Securities). FSP FAS 115-2 and FAS 124-2 amend other-than-temporary impairment guidance for debt securities to make guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities. The FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. FSP FAS 115-2 and FAS 124-2 are effective for interim and annual periods ending after June 15, 2009, with earlier adoption permitted for periods ending after March 15, 2009. The Bank does not expect the adoption of FSP FAS 115-2 and FAS 124-2 to have a material impact on its consolidated financial statements.

In April 2009, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 111 (SAB 111). SAB 111 amends and replaces SAB Topic 5.M. in the SAB Series entitled “Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities.” SAB 111 maintains the SEC Staff’s previous views related to equity securities and amends Topic 5.M. to exclude debt securities from its scope. The Bank does not expect the implementation of SAB 111 to have a material impact on its consolidated financial statements.

In May 2009, the FASB issued Statement of Financial Accounting Standards No. 165, “Subsequent Events” (ASC 855 Subsequent Events). SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS 165 is effective for interim and annual periods ending after June 15, 2009. The Bank does not expect the adoption of SFAS 165 to have a material impact on its consolidated financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 166, “Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140” (ASC 860 Transfers and Servicing). SFAS 166 provides guidance to improve the relevance, representational faithfulness, and comparability of the information that a report entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets. SFAS 166 is effective for interim and annual periods beginning after November 15, 2009. The Bank does not expect the adoption of SFAS 166 to have a material impact on its consolidated financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 167, “Amendments to FASB Interpretation No. 46(R)” (ASC 810 Consolidation). SFAS 167 improves financial reporting by enterprises involved with variable interest entities. SFAS 167 is effective for interim and annual periods beginning after November 15, 2009. Early adoption is prohibited. The Bank does not expect the adoption of SFAS 167 to have a material impact on its consolidated financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 168, “The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – replacement of FASB Statement No. 162” (ASC 105 Generally Accepted Accounting Principles). SFAS 168 establishes the FASB Accounting Standards Codification which will become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. SFAS 168 is effective immediately. The Bank does not expect the adoption of SFAS 168 to have a material impact on its consolidated financial statements.

In June 2009, the FASB issued EITF Issue No. 09-1, “Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing” (ASC 470 Debt). EITF Issue No. 09-1 clarifies how an entity should account for an own-share lending arrangement that is entered into in contemplation of a convertible debt offering. EITF Issue No. 09-1 is effective for arrangements entered into on or after June 15, 2009. Early adoption is prohibited. The Bank does not expect the adoption of EITF Issue No. 09-1 to have a material impact on its consolidated financial statements.

In June 2009, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 112 (SAB 112). SAB 112 revises or rescinds portions of the interpretative guidance included in the codification of SABs in order to make the interpretive guidance consistent with current U.S. GAAP. The Bank does not expect the adoption of SAB 112 to have a material impact on its consolidated financial statements.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05 (ASU 2009-05), “Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value.” ASU 2009-05 amends Subtopic 820-10, “Fair Value Measurements and Disclosures – Overall,” and provides clarification for the fair value measurement of liabilities. ASU 2009-05 is effective for the first reporting period including interim period beginning after issuance. The Bank does not expect the adoption of ASU 2009-05 to have a material impact on its consolidated financial statements.

In September 2009, the FASB issued Accounting Standards Update No. 2009-12 (ASU 2009-12), “Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent).” ASU 2009-12 provides guidance on estimating the fair value of alternative investments. ASU 2009-12 is effective for interim and annual periods ending after December 15, 2009. The Bank does not expect the adoption of ASU 2009-12 to have a material impact on its consolidated financial statements.

In October 2009, the FASB issued Accounting Standards Update No. 2009-15 (ASU 2009-15), “Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing.” ASU 2009-15 amends Subtopic 470-20 to expand accounting and reporting guidance for own-share lending arrangements issued in contemplation of convertible debt issuance. ASU 2009-15 is effective for fiscal years beginning on or after December 15, 2009 and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The Bank does not expect the adoption of ASU 2009-15 to have a material impact on its consolidated financial statements.

In October 2009, the Securities and Exchange Commission issued Release No. 33-99072, “Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers.” Release No. 33-99072 delays the requirement for non-accelerated filers to include an attestation report of their independent auditor on internal control over financial reporting with their annual report until the fiscal year ending on or after June 15, 2010.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Not Required for Small Reporting Companies

## **Item 4. Controls and Procedures**

### **Disclosure Controls and Procedures**

The Bank's management, with the participation of the Bank's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Bank's disclosure controls and procedures as of the end of the period covered by this report. Based on such evaluation, the Bank's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Bank's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Bank in the reports that it files or furnishes under the Securities Exchange Act of 1934.

Management reviews and evaluates the design and effectiveness of the Bank's disclosure controls and procedures on an ongoing basis, which may result in the discovery of deficiencies, and improves its controls and procedures over time, correcting any deficiencies, as needed, that may have been discovered.

### **Changes in Internal Control Over Financial Reporting**

Management reviews and evaluates the design and effectiveness of the Bank's internal control over financial reporting on an ongoing basis, which may result in the discovery of deficiencies, some of which may be significant. Management changes its internal control over financial reporting as needed to maintain its effectiveness, correcting any deficiencies, as needed, in order to ensure the continued effectiveness of the Bank's internal control over financial reporting. There have not been any changes in the Bank's internal control over financial reporting during the third quarter of 2009 that have materially affected, or are reasonably likely to materially affect, the Bank's internal control over financial reporting.

For management's assessment of the Bank's internal control over financial reporting, refer to the Bank's 2008 Annual Report on Form 10-K, "Management's Report on Internal Control over Financial Reporting."

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

None

### **Item 2. Unregistered Sales of Equity Securities or Use of Proceeds**

None

### **Item 3. Defaults Upon Senior Securities**

Not applicable

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

None

### **Item 5. Other Information**

#### **(a) Required 8-K Disclosures**

None

#### **(b) Changes in Procedures for Director Nominations by Security Holders**

None

## Item 6. Exhibits

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

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

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

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

\*\*\* Incorporated herein by reference from the Bank's Annual Report on Form 10-KSB for the year ended December 31, 2008, filed with the Board of Governors of the Federal Reserve System on March 10, 2009.

† Filed herewith.

## **SIGNATURES**

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

### **BANK OF MCKENNEY**

Date: November 13, 2009

\_\_\_\_\_  
Richard M. Liles  
President and Chief Executive Officer

Date: November 13, 2009

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

## SECTION 302 CERTIFICATION

I, Richard M. Liles, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Bank of McKenney;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit any 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the 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
  - (d) 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.

Date: November 13, 2009

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Richard M. Liles  
President and Chief Executive Officer

## SECTION 302 CERTIFICATION

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

1. I have reviewed this quarterly report on Form 10-Q of Bank of McKenney;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit any 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the 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
  - (d) 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.

Date: November 13, 2009

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

**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 Quarterly Report of Bank of McKenney (the “Bank”) on Form 10-Q for the period ending September 30, 2009 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.

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Richard M. Liles  
President and Chief Executive Officer

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

Dated: November 13, 2009