

# Board of Governors of the Federal Reserve System

Washington, D.C. 20551

## Form 10-QSB

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

For the quarterly period ended September 30, 2007

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

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

### BANK OF MCKENNEY

(Exact Name of Small Business Issuer as Specified in its charter)

**Virginia**

(State or other jurisdiction of incorporation or organization)

**54-0132540**

(IRS employer identification no.)

**20718 First Street**

**McKenney, Virginia**

(Address of principal executive offices)

**23872**

(Zip Code)

Issuer's telephone number (804) 478-4434

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

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):   YES  X  NO

State the number of shares outstanding of each of the issuer's classes of common equity, as of the last practical date (November 9, 2007):

1,926,656 shares of Common Stock, par value \$2.00 per share

Transitional Small Business Disclosure Format:   YES  X  NO

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## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements

#### BANK OF MCKENNEY AND SUBSIDIARY

#### Consolidated Balance Sheets

September 30, 2007 (unaudited) and December 31, 2006

	September 30, 2007	December 31, 2006
<b>ASSETS</b>		
Cash and due from banks	\$ 3,575,750	\$ 4,179,157
Federal funds sold	2,974,000	5,265,000
Securities available for sale, at fair market value	28,288,078	27,906,220
Restricted investments	1,274,025	1,285,125
Loans:		
Commercial	7,647,595	7,647,649
Commercial Real Estate	47,814,324	47,519,614
Real Estate Construction	11,960,350	7,928,957
Residential Real Estate	37,362,335	35,956,874
Consumer	2,680,536	2,918,410
Loans, gross	\$ 107,465,140	\$ 101,971,504
Less allowance for loan losses	(879,214)	(1,070,000)
Loans, net	\$ 106,585,926	\$ 100,901,504
Land, premises and equipment, net	7,779,181	6,864,254
Other real estate owned	90,139	-
Accrued interest receivable	825,555	848,180
Bank owned life insurance	2,968,622	2,877,937
Other assets	1,744,463	1,751,371
<b>Total Assets</b>	<b>\$ 156,105,739</b>	<b>\$ 151,878,748</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing deposits	\$ 23,993,647	\$ 23,890,991
Savings and interest bearing demand deposits	27,483,174	30,515,050
Time deposits	71,403,841	64,855,562
Total deposits	\$ 122,880,662	\$ 119,261,603
Federal Home Loan Bank advances	13,750,000	14,000,000
Accrued interest payable	396,053	336,015
Accrued expenses and other liabilities	1,015,460	1,363,477
Total Liabilities	\$ 138,042,175	\$ 134,961,095
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	8,447,642	7,467,215
Accumulated other comprehensive loss	(131,348)	(296,832)
Total shareholders' equity	\$ 18,063,564	\$ 16,917,653
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 156,105,739</b>	<b>\$ 151,878,748</b>

See Notes to Unaudited Consolidated Financial Statements

**BANK OF MCKENNEY AND SUBSIDIARY**  
**Consolidated Statements of Income**  
(unaudited)

Three Months Ended  
September 30,

Nine Months Ended  
September 30,

<b>Interest and Dividend Income:</b>	2007	2006	2007	2006
Interest and fees on loans	\$ 2,126,453	\$ 1,989,284	\$ 6,135,785	\$ 5,724,784
Interest and dividends on securities - taxable	297,783	301,156	843,880	798,563
Interest on securities - nontaxable	20,115	12,605	54,258	32,394
Interest on federal funds sold	57,780	16,158	265,262	109,331
Interest on deposits with other institutions	8,949	4,974	22,055	54,175
Total interest and dividend income	<u>\$ 2,511,080</u>	<u>\$ 2,324,177</u>	<u>\$ 7,321,240</u>	<u>\$ 6,719,247</u>
<b>Interest Expense:</b>				
Money market and NOW accounts	\$ 38,910	\$ 44,332	\$ 123,260	\$ 126,226
Savings	19,208	19,317	59,159	58,932
Time	812,325	643,583	2,295,905	1,723,189
Federal Funds Purchased & Securities Sold	-	2,064	-	2,064
Federal Home Loan Bank advances	164,324	168,356	490,579	502,525
Other borrowed funds	-	8	-	297
Total interest expense	<u>\$ 1,034,767</u>	<u>\$ 877,660</u>	<u>\$ 2,968,903</u>	<u>\$ 2,413,233</u>
Net interest income	\$ 1,476,313	\$ 1,446,517	\$ 4,352,337	\$ 4,306,014
Provision for loan losses	30,000	-	50,000	20,000
Net interest income after provision for loan losses	<u>\$ 1,446,313</u>	<u>\$ 1,446,517</u>	<u>\$ 4,302,337</u>	<u>\$ 4,286,014</u>
<b>Noninterest income:</b>				
Service charges on deposit accounts	\$ 205,981	\$ 188,433	\$ 614,103	\$ 545,503
Secondary market origination fees	98,886	115,477	288,085	314,346
Net gain (loss) on sale of securities	(359)	(24,885)	67,376	(20,837)
Bank-owned life insurance	31,229	29,474	90,685	84,269
Other operating income	48,095	40,714	140,337	142,626
Gain on sale of fixed assets	5,627	-	57,276	4,000
Total noninterest income	<u>\$ 389,459</u>	<u>\$ 349,213</u>	<u>\$ 1,257,862</u>	<u>\$ 1,069,907</u>
<b>Noninterest expense:</b>				
Salaries and employee benefits	\$ 867,636	\$ 871,058	\$ 2,579,673	\$ 2,542,891
Occupancy expense	75,971	78,233	236,836	232,419
Furniture and equipment expense	116,539	114,016	327,213	328,698
Data processing	54,466	40,824	156,246	120,095
Telecommunications	26,566	25,367	81,087	77,027
Stationery and supplies	20,922	30,059	74,427	92,094
Audit and accounting fees	44,822	39,960	126,359	110,471
Corporate franchise tax	28,251	27,809	85,373	83,357
Other operating expenses	158,267	171,194	494,602	458,018
Total noninterest expense	<u>\$ 1,393,440</u>	<u>\$ 1,398,520</u>	<u>\$ 4,161,816</u>	<u>\$ 4,045,070</u>
Net income before taxes	\$ 442,332	\$ 397,210	\$ 1,398,383	\$ 1,310,851
Income taxes	132,542	121,348	417,956	403,796
<b>Net income</b>	<u>\$ 309,790</u>	<u>\$ 275,862</u>	<u>\$ 980,427</u>	<u>\$ 907,055</u>
Net income per common share, basic and diluted	<u>\$ 0.16</u>	<u>\$ 0.14</u>	<u>\$ 0.51</u>	<u>\$ 0.47</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, 2007 and 2006  
(unaudited)

	<u>Common Stock</u>	<u>Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Comprehensive Income</u>	<u>Total</u>
<b>Balance at December 31, 2005</b>	\$3,853,312	\$5,893,958	\$6,682,012	\$ (646,785)		\$ 15,782,497
Comprehensive income:						
Net income	-	-	907,055	-	\$ 907,055	907,055
Other comprehensive income:						
Unrealized holding gains on securities available for sale arising during the period, net of tax of \$112,067	-	-	-	-	217,542	-
Add reclassification adjustment, net of tax benefit of \$7,085	-	-	-	-	13,752	-
Other comprehensive income, net of tax				231,294	<u>\$ 231,294</u>	231,294
Total comprehensive income					<u>\$ 1,138,349</u>	
<b>Balance at September 30, 2006</b>	<u>\$3,853,312</u>	<u>\$5,893,958</u>	<u>\$7,589,067</u>	<u>\$ (415,491)</u>		<u>\$ 16,920,846</u>
<b>Balance at December 31, 2006</b>	\$ 3,853,312	\$ 5,893,958	\$ 7,467,215	\$ (296,832)		\$ 16,917,653
Comprehensive income:						
Net income	-	-	980,427	-	\$ 980,427	980,427
Other comprehensive loss:						
Unrealized holding gains on securities available for sale arising during the period, net of tax of \$108,157	-	-	-		209,952	-
Less reclassification adjustment, net of tax of (\$22,908)	-	-	-		(44,468)	-
Other comprehensive loss, net of tax				165,484	<u>\$ 165,484</u>	165,484
Total comprehensive income					<u>\$ 1,145,911</u>	
<b>Balance at September 30, 2007</b>	<u>\$ 3,853,312</u>	<u>\$ 5,893,958</u>	<u>\$ 8,447,642</u>	<u>\$ (131,348)</u>		<u>\$ 18,063,564</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, 2007 and 2006  
(unaudited)

	2007	2006
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 980,427	\$ 907,055
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	330,796	336,636
Provision for loan losses	50,000	20,000
Increase in cash surrender value of life insurance	(90,685)	(84,269)
Net (gain) loss on sales of securities available for sale	(67,376)	20,837
Net gain on sale of fixed assets	(57,276)	(4,000)
Net amortization of premium on securities	8,732	16,645
Changes in assets and liabilities:		
(Increase) decrease in accrued interest receivable	22,625	(135,839)
Increase in other assets	(88,196)	(244,408)
Increase in accrued interest payable	60,038	98,900
Increase in accrued expenses and other liabilities	133,647	174,293
Net cash provided by operating activities	\$ 1,282,732	\$ 1,105,850
<b>Cash flows from Investing Activities</b>		
Net change in interest-bearing deposits in banks	\$ -	\$ 3,015,123
Activity in available for sale securities:		
Sales	4,008,580	1,974,600
Maturities, prepayments and calls	1,433,605	2,321,565
Purchases	(5,514,665)	(7,160,196)
Net change in restricted securities (FHLB stock)	11,100	(19,900)
Net increase in loans	(5,824,938)	(7,600,394)
Purchase of land, premises and equipment	(1,416,626)	(363,767)
Proceeds from sale of fixed assets	238,410	4,000
Net cash used in investing activities	\$ (7,064,534)	\$ (7,828,969)
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	\$ 3,619,059	\$ 6,856,647
Dividends paid	(481,664)	(423,864)
Payments on FHLB advances and other borrowed funds	(250,000)	(264,447)
Net cash provided by financing activities	\$ 2,887,395	\$ 6,168,336
Net decrease in cash and cash equivalents	\$ (2,894,407)	\$ (554,783)
<b>Cash and Cash Equivalents</b>		
Beginning of period	9,444,157	7,693,836
End of period	\$ 6,549,750	\$ 7,139,053
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash paid during the year for:		
Interest	\$ 2,908,864	\$ 2,314,333
Income Taxes	\$ 487,291	\$ 485,236
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Fair value adjustment for securities	\$ 250,734	\$ 350,455
Transfers from loans to other assets	\$ 90,516	\$ -
Capitalized interest	\$ 9,854	\$ -

See Notes to Unaudited Consolidated Financial Statements

# Notes to Consolidated Financial Statements

## (Unaudited)

### 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 Dinwiddie County, southern Chesterfield County, Prince George County, 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-KSB for the year ended December 31, 2006. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying consolidated financial statements contain all adjustments and reclassifications consisting of normal and recurring items considered necessary to present fairly the financial position as of September 30, 2007 and December 31, 2006, and the results of operations for the three and nine month periods ended September 30, 2007 and 2006 and changes in shareholders’ equity and cash flows for the nine months ended September 30, 2007 and 2006. Operating results for the three and nine month periods ended September 30, 2007 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, 2007 and December 31, 2006:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Market Value</u>
<b>September 30, 2007</b>				
U.S. Government Agencies	\$ 23,649,268	\$ 53,622	\$ (200,653)	\$ 23,502,237
Mortgage-backed securities	378,220	-	(4,543)	373,677
Obligations of state and political subdivisions	2,453,361	2,289	(14,486)	2,441,164
Corporate debt securities	2,006,241	-	(35,241)	1,971,000
	<u>\$ 28,487,090</u>	<u>\$ 55,911</u>	<u>\$ (254,923)</u>	<u>\$ 28,288,078</u>
<b>December 31, 2006</b>				
U.S. Government Agencies	\$ 24,451,593	\$ 61,128	\$ (426,759)	\$ 24,085,962
Mortgage-backed securities	491,185	-	(15,432)	475,753
Obligations of state and political subdivisions	1,400,606	531	(20,632)	1,380,505
Corporate debt securities	2,012,582	-	(48,582)	1,964,000
	<u>\$ 28,355,966</u>	<u>\$ 61,659</u>	<u>\$ (511,405)</u>	<u>\$ 27,906,220</u>

The contractual maturities of investment securities classified as available for sale on September 30, 2007 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>
<b>Available for Sale</b>		
Maturing within one year	\$ 8,386,133	\$ 8,316,924
Maturing after one year, but within five years	11,062,211	10,911,758
Maturing after five years, but within ten years	8,820,630	8,841,312
Maturing after ten years	218,116	218,084
	<u>\$ 28,487,090</u>	<u>\$ 28,288,078</u>

There were no securities pledged to secure public deposits or for other purposes required by law at September 30, 2007. 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 \$1,274,025 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, 2007 and December 31, 2006 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 September 30, 2007 and December 31, 2006 is as follows:

Description	Total		September 30, 2007		12 Months or Greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Agencies	\$ 16,808,616	\$ (200,653)	\$ 2,453,529	\$ (6,391)	\$ 14,355,087	\$ (194,262)
Mortgage Backs	373,677	(4,543)	-	-	373,677	(4,543)
Corporate	1,971,000	(35,241)	-	-	1,971,000	(35,241)
Tax Exempt Municipals	<u>1,726,244</u>	<u>(14,486)</u>	<u>597,010</u>	<u>(1,108)</u>	<u>1,129,234</u>	<u>(13,378)</u>
Total Unrealized Loss Positions	<u>\$ 20,879,537</u>	<u>\$ (254,923)</u>	<u>\$ 3,050,539</u>	<u>\$ (7,499)</u>	<u>\$ 17,828,998</u>	<u>\$ (247,424)</u>

Description	Total		December 31, 2006		12 Months or Greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Agencies	\$ 17,745,652	\$ (426,759)	\$ 3,634,395	\$ (5,605)	\$ 14,111,257	\$ (421,154)
Mortgage Backs	475,753	(15,432)	-	-	475,753	(15,432)
Corporate	1,964,000	(48,582)	-	-	1,964,000	(48,582)
Tax Exempt Municipals	<u>1,124,582</u>	<u>(20,632)</u>	<u>428,716</u>	<u>(4,082)</u>	<u>695,866</u>	<u>(16,550)</u>
Total Unrealized Loss Positions	<u>\$ 21,309,987</u>	<u>\$ (511,405)</u>	<u>\$ 4,063,111</u>	<u>\$ (9,687)</u>	<u>\$ 17,246,876</u>	<u>\$ (501,718)</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, 2007 with unrealized losses consist of fourteen U.S. Agency issues, one governmental mortgage pool issue, two corporate issues, and eight issues of different municipalities. The two corporate credits, Ford Motor Credit and General Motors Acceptance Corporation were downgraded to sub-investment grade during 2005. With the respective issuances being through each corporation's financing arm and the maturities being short (approximately twelve months), no loss is 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.

### 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, 2007 and 2006:

	September 30,	
	2007	2006
Balance, beginning of period	\$ 1,070,000	\$ 1,025,000
Provision for loan losses	50,000	20,000
Total loan chargeoffs	(254,984)	(5,604)
Recoveries of loans previously charged off	14,198	11,676
Balance, end of period	<u>\$ 879,214</u>	<u>\$ 1,051,072</u>
Allowance for loan losses to total loans	<u>0.82%</u>	<u>1.03%</u>

### 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,			
	2007		2006		2007		2006	
	Shares	Per Share	Shares	Per Share	Shares	Per Share	Shares	Per Share
Basic & Diluted earnings per share	<u>1,926,656</u>	<u>\$ 0.16</u>	<u>1,926,656</u>	<u>\$ 0.14</u>	<u>1,926,656</u>	<u>\$ 0.51</u>	<u>1,926,656</u>	<u>\$ 0.47</u>

## 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 2007 and 2006 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 non-collectability 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 collectability 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.

## **Branch Sites and Branch Openings**

In January 2007, the Board decided to consolidate the two Chesterfield locations and announced the closure of the Ettrick branch in June 2007. The Ettrick location, a former Central Fidelity branch, was re-opened in 1998 by the Bank in an effort to offer the citizenry financial services. Since that time, the Matoaca and Colonial Heights branches have been established and incorporate more staff, expanded drive through lanes, and ATM facilities. These enhancements are physically impossible to add at the small Ettrick structure, and many patrons had already begun to frequent the newer branches. Customers were notified, and the Ettrick office closed as planned on June 1<sup>st</sup>, 2007. Subsequently, the site was sold on June 13<sup>th</sup>, 2007 to a local business for non-financial service purposes.

In June 2006, the Bank opened a temporary location at 4112A Commerce Road near the intersection of Middle Road and Prince George Drive in Prince George County. Since its opening, the temporary site has generated over \$2 million in loans and \$1 million in deposits which is especially significant in light of the fact that the temporary office does not include drive-up or on-site ATM facilities. During April 2007, the Bank received the required permits and has begun construction on the permanent Prince George office at 4700 Owens Way, which is situated directly across from the Jefferson Parkway gate of Fort Lee and approximately 2 miles east of the temporary location. The new site is being constructed to include all the services and facilities traditionally found in financial institutions as well as office space for lease in this growing area. The approximate opening date of this office is expected to be December 2007.

## **Comparison of Financial Condition at September 30, 2007 and December 31, 2006**

At the end of the third quarter, total assets were \$156.1 million, representing a \$4.2 million or 2.76% increase over the December 31, 2006 level of \$151.9 million. Total deposits amounted to \$122.9 million as of September 30, 2007, which represents a 3.02% increase from the \$119.3 million level as of December 31, 2006. During the same period, total loans expanded by 5.39% or \$5.5 million to the September 30, 2007 balance of \$107.5 million. On an annualized basis, loans and deposits grew during the first three quarters at a rate of 7.16% and 4.02%, respectively. At September 30, 2007, the investment portfolio stood at \$29.6 million, a 1.37% increase in comparison to the December 31, 2006 \$29.2 million level. Overnight federal funds sold decreased 43.40% from \$5.3 million on December 31, 2006 to \$3.0 million on September 30, 2007. Cumulatively, earning assets grew \$3.6 million through the third quarter or 3.52% on an annualized basis and represent 89.75% of total assets.

The allowance for loan losses was \$879,000 as of September 30, 2007, or 0.82% of loans outstanding, compared to \$1,070,000 as of December 31, 2006 or 1.05% of outstanding loans. During the year, the Bank has concluded the liquidation of certain non-performing and impaired debts, and charged off approximately \$255,000 to reserves. The Bank works diligently to maintain quality in its loan portfolio and has historically maintained a delinquency ratio below 1%. Loans past due more than thirty days (excluding impaired and nonaccrual loans) decreased \$445,000 to \$318,000 or 0.30% of total loans at September 30, 2007 as compared to December 31, 2006 delinquencies of \$763,000, or 0.75% of total loans.

Non-performing assets consist of impaired loans, non-accrual loans and real estate owned by the Bank resulting from a foreclosure proceeding. Normally, 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 September 30, 2007, non-performing assets stood at \$1.1 million or 1.02% of third quarter-end loans. This compared to non-performing assets of \$1.56 million, or 1.53%, of total loans outstanding for December 31, 2006.

## **Comparison of Results of Operations for the Nine Months Ended September 30, 2007 and 2006**

For the nine-month period ended September 30, 2007, the Bank reported earnings of \$980,000, an increase of 8.05% when compared to \$907,000 through the first nine months of 2006. For the first three quarters of 2007, earnings per basic and diluted share climbed to \$0.51 or \$0.04 over the \$0.47 recorded the same period in the prior year. Annualized returns on average assets and average equity for the first nine months of 2007 were 0.85% and 7.48%, respectively, compared to 0.82% and 7.39%, respectively, for the same period in 2006. As has been the case in recent periods, higher cost of funds for deposits continue to place pressure on interest margins. Nonetheless, segments of the investment and loan portfolio are beginning to re-price, and this process will continue through 2008 and 2009. The current margin squeeze is deemed temporary and is forecasted to gain a growth momentum as the present rate cycle plays out.

*Net interest income.* Net interest income increased 1.07% to \$4,352,000 in the first nine months of 2007 from \$4,306,000 in the comparable period in 2006. This was primarily due to a year-over-year increase of 4.11% in average loans to \$103.8 million from \$99.7 million as well as a \$3.8 million increase in the average overnight funds from \$3.1 million to \$6.9 million both of which also demonstrated improved rate performance. The growth in earning asset rates and volume was somewhat offset by higher rates demanded to remain locally competitive in the deposit products offered. As of September 30, 2007, the net interest margin lowered 19 basis points to 4.21% in the third quarter of 2007 from 4.40% for the same period in 2006. Nonetheless, this impact is expected to fully negate itself as the balance of the asset re-pricing cycle completes over the next twelve to eighteen months.

*Noninterest income.* Noninterest income, exclusive of securities and trading transactions, grew 9.07% from \$1,091,000 in the first nine months of 2006 to \$1,190,000 for the same period in 2007. Deposit service charges climbed \$68,000 or 12.45% when comparing the first three quarters of 2007 to that of 2006. The bank holds certain long-term investments in bank-owned life insurance (BOLI) on officers of the corporation. The investments follow current market trends, resetting annually with regard to rates, and provide a tax-free revenue stream to help offset the rising costs of employee benefits which is generally higher than other prevailing tax-exempt investment vehicles. For the nine months ended September 30, 2007, BOLI revenue equaled \$91,000 or 8.33% above that of the \$84,000 recognized through September 30, 2006. For the same nine month period, other noninterest income, including revenues from the bank's mortgage and appraisal departments, the insurance and investment subsidiary, and gains on disposals of fixed assets, increased \$25,000 or 5.42% from \$461,000 in 2006 to \$486,000 in 2007.

*Noninterest expense.* Noninterest expense increased 2.89% to \$4,162,000 through the third quarter 2007 from \$4,045,000 for the same period in 2006. Salaries and benefits rose only modestly by 1.45% or \$37,000 while occupancy and furniture equipment expenses grew only \$3,000 or 0.53%. Other operating expenses climbed 8.18% or \$77,000 led primarily by increased audit and data processing costs.

*Provision for loan losses.* Provision for loan losses increased from \$20,000 through September 30, 2006 to \$50,000 for the nine months ended September 30, 2007. This greater allocation is based on managements' estimate of the amount necessary to maintain the allowance for loan losses at a level considered adequate to provide for losses which are or may be inherent in the loan portfolio.

*Income Taxes.* The Bank's income tax provisions are adjusted for non-deductible expenses and non-taxable interest after applying the U.S. federal income tax rate of 34%. Provision for income taxes totaled \$418,000 and \$404,000 for the nine months ended September 30, 2007 and 2006, respectively.

## **Comparison of Results of Operations for the Three Months Ended September 30, 2007 and 2006**

For the three-month period ending September 30, 2007, net income amounted to \$310,000. This represents a 12.32% increase when compared to net income of \$276,000 for the same period in 2006. Basic and diluted earnings per share was \$0.16 for the three months ended September 30, 2007 on 1,926,656 weighted average shares outstanding compared to a prior year basic and diluted earnings per share of \$0.14 during the same period with the equivalent weighted average shares outstanding. As noted after the close of the third quarter, higher cost of funds for deposits continue to place pressure on interest margins; however, earning asset yields are improving as more of the loans and investments contained therein re-price.

*Net interest income.* Net interest income increased 2.00% to \$1,476,000 in the third quarter of 2007 from \$1,447,000 in the comparable period in 2006. This was primarily due to a volume growth in average balances in both the loan and short-term investment portfolios. To a significant degree, however, this volume growth has been offset by higher deposit rates commanded by local markets through the second and third quarters. While this pressure remains, the asset-re-pricing cycle is beginning to demonstrate yield growth at a pace greater than cost of funds which should translate into improving margins in the near future.

*Noninterest income.* Noninterest income, exclusive of securities transactions, climbed 4.28% from \$374,000 in the third quarter of 2006 to \$390,000 for the same period in 2007. Service charges grew 9.57% during the third quarter 2007 period to \$206,000 when compared to the third quarter 2006 level of \$188,000. The secondary market mortgage department was lower by 13.91% recording revenue for the 2007 third quarter of \$99,000 as compared to the \$115,000 same period in 2006. Other noninterest vehicles, including the insurance and investment subsidiary, experienced modest gains in revenue for the third quarter of 2007 reporting \$79,000 which represents a 12.86% boost over the third quarter 2006 level of \$70,000. Gains on the sale of fixed assets of \$6,000 were posted during the third quarter of 2007.

*Noninterest expense.* Noninterest expense decreased slightly by 0.43% to \$1,393,000 during the quarter ended September 30, 2007 from \$1,399,000 for the same period in 2006. Salaries and benefits were lower by 0.34% or \$3,000 while occupancy and furniture equipment expenses increased \$1,000 or 0.52%. Numerous projects aimed at improved efficiencies and growth are underway and slated to be completed by year's end including the centralization and combination of loan processing with all retail operations, and the planning and preparation for the new Prince George branch. As a result of these efforts, other operating expenses declined by \$4,000 or 1.19% when comparing the third quarter of 2007 to those reported in same period of 2006.

*Provision for loan losses.* During the third quarter of 2007, a provision allocation of \$30,000 was made based on managements' estimate of the amount necessary to maintain the allowance for loan losses at a level considered adequate to provide for losses which are or may be inherent in the loan portfolio. No provisions for loan losses were made during the same three-month period in 2006.

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**

	Nine Months Ended September 30,					
	2007			2006		
	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>	\$ 27,588	\$ 920	4.45%	\$ 27,122	\$ 838	4.12%
Interest-bearing balances with banks	585	22	5.03%	1,161	54	6.22%
Loans	103,845	6,136	7.90%	99,682	5,725	7.68%
Federal funds sold	6,883	265	5.15%	3,124	109	4.66%
Total interest earning assets	<u>138,901</u>	<u>7,343</u>	<u>7.07%</u>	<u>131,089</u>	<u>6,726</u>	<u>6.86%</u>
Non-interest earning assets:						
Cash and due from banks	3,703			4,726		
Premises and equipment	7,084			6,839		
Other assets	5,543			5,358		
Less: Allowance for loan losses	(961)			(1,048)		
	<u>15,369</u>			<u>15,875</u>		
	<u>\$154,270</u>			<u>\$146,964</u>		
Liabilities and Shareholders' Equity						
Interest bearing liabilities:						
Interest-bearing demand deposits	\$ 9,744	\$ 26	0.36%	\$ 10,612	\$ 29	0.37%
Money market deposit accounts	6,879	97	1.89%	7,909	97	1.64%
Savings accounts	13,199	59	0.60%	13,173	59	0.60%
Time deposits	68,008	2,296	4.51%	60,934	1,723	3.78%
Total interest-bearing deposits	<u>97,830</u>	<u>2,478</u>	<u>3.39%</u>	<u>92,628</u>	<u>1,908</u>	<u>2.75%</u>
Federal funds purchased and securities sold	-	-	0.00%	45	2	5.94%
FHLB Advances	13,884	491	4.73%	14,217	503	4.73%
Other borrowings	-	-	0.00%	5	0	8.02%
Total interest-bearing liabilities	<u>111,714</u>	<u>2,969</u>	<u>3.55%</u>	<u>106,895</u>	<u>2,413</u>	<u>3.02%</u>
Non-interest bearing liabilities:						
Demand deposits	23,706			22,530		
Other liabilities	1,342			1,171		
Total liabilities	<u>136,762</u>			<u>130,596</u>		
Shareholders' Equity	<u>17,508</u>			<u>16,368</u>		
Total Liabilities & Shareholders' Equity	<u>\$154,270</u>			<u>\$146,964</u>		
Interest Spread <sup>(2)</sup>			3.52%			3.84%
Net Interest Margin <sup>(3)</sup>		<u>\$ 4,374</u>	4.21%		<u>\$ 4,313</u>	4.40%

(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.

## Liquidity and Capital

The liquidity ratio on September 30, 2007 lowered to 26.43% compared to 28.99% reported as of December 31, 2006. 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, 2007 and December 31, 2006:

<b>Risk Based Capital Analysis</b>			
	September 30, 2007	December 31, 2006	
(Dollars in Thousands)			
Tier 1 Capital:			
Common stock	\$ 3,853	\$ 3,853	
Capital surplus	5,894	5,894	
Retained earnings	8,317	7,171	
Reverse: Unrealized (Gains)/Losses	131	296	
Total tier 1 capital	<u>18,195</u>	<u>17,214</u>	
Tier 2 Capital:			
Allowance for loan losses	<u>879</u>	<u>1,070</u>	
Tier 3 Capital:			
Deductions for investments in banking and finance subsidiaries	<u>(140)</u>	<u>(140)</u>	
Total Risk Based Capital	<u>\$ 18,934</u>	<u>\$ 18,144</u>	
Risk weighted assets	<u>\$ 116,193</u>	<u>\$ 112,137</u>	
Quarterly average assets	<u>\$ 155,560</u>	<u>\$ 150,344</u>	
Capital Ratios:	September 30, 2007	December 31, 2006	Regulatory Minimum
Tier 1 risk based capital ratio	15.66%	15.35%	4.00%
Total risk based capital ratio	16.30%	16.18%	8.00%
Leverage ratio	11.70%	11.45%	4.00%

## **Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Bank does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Bank is in the process of evaluating the impact SFAS 159 may have on its consolidated financial statements.

## **Item 3. 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 date of this quarterly report filed on Form 10-QSB. 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 and other procedures that 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, are accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

**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-QSB, 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 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, 2004, filed with the Board of Governors of the Federal Reserve System on March 8, 2005.

† 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, 2007

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

Date: November 13, 2007

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

Date: November 13, 2007

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

Date: November 13, 2007

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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-QSB for the period ending September 30, 2007 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, 2007