

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, 2008

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

**APPLICABLE ONLY TO ISSURERS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by the court.

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 10, 2008)

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

September 30, 2008 (unaudited) and December 31, 2007

ASSETS	September 30 2008	December 31, 2007
Cash and due from banks	\$ 3,520,586	\$ 3,666,898
Federal funds sold	3,041,000	7,557,000
Interest-bearing time balances in other banks	1,526,667	--
Securities available for sale, at fair market value	30,144,532	28,807,961
Restricted investments	974,525	1,274,025
Loans:		
Commercial	8,378,008	7,607,912
Commercial real estate	47,008,342	45,470,030
Real estate construction	11,557,352	12,287,132
Residential real estate	42,871,661	39,050,277
Consumer	2,421,493	2,612,284
Loans, gross	\$ 112,236,856	\$ 107,027,635
Less allowance for loan losses	(1,015,013)	(925,000)
Loans, net	\$ 111,221,843	\$ 106,102,635
Land, premises and equipment, net	8,267,673	8,361,377
Other real estate owned	197,817	--
Accrued interest receivable	896,580	752,668
Bank owned life insurance	3,094,556	2,999,852
Other assets	2,479,619	1,669,037
Total Assets	\$ 165,365,398	\$ 161,191,453
LIABILITIES		
Deposits:		
Noninterest-bearing deposits	\$ 25,256,546	\$ 24,279,539
Savings and interest bearing demand deposits	36,379,482	28,556,694
Time deposits	77,207,440	74,682,839
Total deposits	\$ 138,843,468	\$ 127,519,072
Federal Home Loan Bank advances	7,416,666	13,666,667
Accrued interest payable	352,610	416,040
Accrued expenses and other liabilities	1,126,403	1,520,973
Total Liabilities	\$ 147,739,147	\$ 143,122,752
Commitments and contingencies	\$ --	\$ --
SHAREHOLDERS' EQUITY		
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	9,158,593	8,240,118
Accumulated other comprehensive income (loss)	(1,279,612)	81,313
Total shareholders' equity	\$ 17,626,251	\$ 18,068,701
Total Liabilities and Shareholders' Equity	\$ 165,365,398	\$ 161,191,453

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,	
	2008	2007	2008	2007
Interest and Dividend Income:				
Interest and fees on loans	\$ 2,098,105	\$ 2,126,453	\$ 6,280,757	\$ 6,135,785
Interest and dividends on securities - taxable	373,570	297,783	1,023,261	843,880
Interest on securities - nontaxable	38,917	20,115	111,698	54,258
Interest on federal funds sold	5,535	57,780	91,436	265,262
Interest on deposits with other institutions	27,386	8,949	57,661	22,055
Total interest and dividend income	<u>\$ 2,543,513</u>	<u>\$ 2,511,080</u>	<u>\$ 7,564,813</u>	<u>\$ 7,321,240</u>
Interest Expense:				
Money market and NOW accounts	\$ 81,751	\$ 38,910	\$ 200,366	\$ 123,260
Savings	17,149	19,208	53,044	59,159
Time	769,684	812,325	2,425,172	2,295,905
Federal funds purchased & securities sold	3,728	--	3,728	--
Federal Home Loan Bank advances	88,980	164,324	403,585	490,579
Total interest expense	<u>\$ 961,292</u>	<u>\$ 1,034,767</u>	<u>\$ 3,085,895</u>	<u>\$ 2,968,903</u>
Net interest income	\$ 1,582,221	\$ 1,476,313	\$ 4,478,918	\$ 4,352,337
Provision for loan losses	50,000	30,000	210,000	50,000
Net interest income after provision for loan losses	<u>\$ 1,532,221</u>	<u>\$ 1,446,313</u>	<u>\$ 4,268,918</u>	<u>\$ 4,302,337</u>
Noninterest income:				
Service charges on deposit accounts	\$ 217,723	\$ 205,981	\$ 639,104	\$ 614,103
Secondary market origination fees	112,407	98,886	342,381	288,085
Net gain/(loss) on sale of securities	(234)	(359)	250,238	67,376
Bank-owned life insurance	32,275	31,229	94,705	90,685
Other operating income	56,773	48,095	159,916	140,337
Gain on sale of other real estate owned	--	--	9,579	--
Gain on sale of fixed assets	--	5,627	--	57,276
Total noninterest income	<u>\$ 418,944</u>	<u>\$ 389,459</u>	<u>\$ 1,495,923</u>	<u>\$ 1,257,862</u>
Noninterest expense:				
Salaries and employee benefits	\$ 911,067	\$ 867,636	\$ 2,727,016	\$ 2,579,673
Occupancy expense	95,177	75,971	279,041	236,836
Furniture and equipment expense	129,828	116,539	359,022	327,213
Data processing	60,197	54,466	164,317	156,246
Telecommunications	36,783	26,566	106,066	81,087
Stationery and supplies	19,563	20,922	65,665	74,427
Audit and accounting fees	44,984	44,822	136,724	126,359
Corporate franchise tax	30,876	28,251	92,626	85,373
Other operating expenses	190,085	158,267	548,827	494,602
Total noninterest expense	<u>\$ 1,518,560</u>	<u>\$ 1,393,440</u>	<u>\$ 4,479,304</u>	<u>\$ 4,161,816</u>
Net income before taxes	\$ 432,605	\$ 442,332	\$ 1,285,537	\$ 1,398,383
Income taxes	128,032	132,542	367,062	417,956
Net income	<u>\$ 304,573</u>	<u>\$ 309,790</u>	<u>\$ 918,475</u>	<u>\$ 980,427</u>
Net income per common share, basic and diluted	<u>\$ 0.16</u>	<u>\$ 0.16</u>	<u>\$ 0.48</u>	<u>\$ 0.51</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, 2008 and 2007
(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>
Balance at December 31, 2006	\$ 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 income:						
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 income, net of tax				165,484	<u>\$ 165,484</u>	165,484
Total comprehensive income					<u>\$ 1,145,911</u>	
Balance at September 30, 2007	<u>\$ 3,853,312</u>	<u>\$ 5,893,958</u>	<u>\$ 8,447,642</u>	<u>\$ (131,348)</u>		<u>\$ 18,063,564</u>
Balance at December 31, 2007	\$ 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)	<u>\$ (1,360,925)</u>	(1,360,925)
Total comprehensive loss					<u>\$ (442,450)</u>	
Balance at September 30, 2008	<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>

See Notes to Unaudited Consolidated Financial Statements

BANK OF MCKENNEY AND SUBSIDIARY

Consolidated Statements of Cash Flows

For the Nine Months Ended September 30, 2008 and 2007

(unaudited)

	<u>2008</u>	<u>2007</u>
Cash Flows from Operating Activities		
Net income	\$ 918,475	\$ 980,427
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	375,630	330,796
Provision for loan losses	210,000	50,000
Capitalized interest on interest-bearing deposits in banks	(26,667)	-
Increase in cash surrender value of life insurance	(94,704)	(90,685)
Net gain on sales of securities available for sale	(250,239)	(67,376)
Net gain on sales of fixed assets	-	(57,276)
Net gain on sales of other real estate owned	(9,579)	-
Net amortization of premium on securities	(58,369)	8,732
Changes in assets and liabilities:		
(Increase) Decrease in accrued interest receivable	(143,912)	22,625
Increase in other assets	(109,501)	(88,196)
Increase (Decrease) in accrued interest payable	(63,430)	60,038
Increase in accrued expenses and other liabilities	125,627	133,647
Net cash provided by operating activities	<u>\$ 873,331</u>	<u>\$ 1,282,732</u>
Cash flows from Investing Activities		
Net change in interest-bearing deposits in banks	\$ (1,500,000)	\$ -
Activity in available for sale securities:		
Sales	7,227,306	4,008,580
Maturities, prepayments and calls	15,834,587	1,433,605
Purchases	(26,151,862)	(5,514,665)
Redemption of restricted securities (FHLB stock)	299,500	11,100
Net increase in loans	(5,663,686)	(5,734,422)
Purchase of land, premises and equipment	(280,265)	(1,416,626)
Proceeds from sale of fixed assets	-	(90,516)
Proceeds from sale of other real estate owned	144,579	238,410
Net cash used in investing activities	<u>\$ (10,089,841)</u>	<u>\$ (7,064,534)</u>
Cash Flows from Financing Activities		
Net increase in deposits	\$ 11,324,396	\$ 3,619,059
Dividend distributions	(520,197)	(481,664)
Repayment of long-term debt	(6,250,001)	(250,000)
Net cash provided by financing activities	<u>\$ 4,554,198</u>	<u>\$ 2,887,395</u>
Net decrease in cash and cash equivalents	\$ (4,662,312)	\$ (2,894,407)
Cash and Cash Equivalents		
Beginning of year	<u>11,223,898</u>	<u>9,444,157</u>
End of Year	<u>\$ 6,561,586</u>	<u>\$ 6,549,750</u>
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest	<u>\$ 3,149,325</u>	<u>\$ 2,908,864</u>
Income Taxes	<u>\$ 391,800</u>	<u>\$ 487,291</u>
Supplemental Disclosures of Noncash Investing and Financing Activities		
Fair value adjustment for securities	<u>\$ (2,062,006)</u>	<u>\$ 250,734</u>
Capitalized interest	<u>\$ -</u>	<u>\$ 9,854</u>

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-KSB for the year ended December 31, 2007. 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, 2008 and December 31, 2007 and the results of operations for the three and nine month periods ended September 30, 2008 and 2007 and changes in shareholders’ equity and cash flows for the nine months ended September 30, 2008 and 2007. Operating results for the three and nine-month periods ended September 30, 2008 and 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, 2008 and December 31, 2007:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Market Value</u>
September 30, 2008				
U.S. government agencies	\$ 12,200,345	\$ 79,067	\$ (13,640)	\$ 12,265,772
Mortgage-backed securities	1,250,312	11,670	-	1,261,982
Obligations of state and political subdivisions	4,236,320	9,902	(80,642)	4,165,580
Corporate debt securities	14,396,360	12,043	(1,957,205)	12,451,198
	<u>\$ 32,083,337</u>	<u>\$ 112,682</u>	<u>\$ (2,051,487)</u>	<u>\$ 30,144,532</u>
December 31, 2007				
U.S. government agencies	\$ 22,152,627	\$ 196,797	\$ (73,853)	\$ 22,275,571
Mortgage-backed securities	1,827,579	39	(2,100)	1,825,518
Obligations of state and political subdivisions	3,700,426	34,075	(2,629)	3,731,872
Corporate debt securities	1,004,127	-	(29,127)	975,000
	<u>\$ 28,684,759</u>	<u>\$ 230,911</u>	<u>\$ (107,709)</u>	<u>\$ 28,807,961</u>

The contractual maturities of investment securities classified as available for sale on September 30, 2008 are shown below. Expected maturities may differ from contractual maturities because mortgages underlying the mortgage-backed securities may be called or prepaid without any penalties.

	<u>Amortized Cost</u>	<u>Fair Market Value</u>
Available for Sale		
Maturing within one year	\$ 1,000,000	\$ 1,000,000
Maturing after one year, but within five years	16,205,985	15,861,546
Maturing after five years, but within ten years	13,353,636	11,755,184
Maturing after ten years	1,523,716	1,527,802
	<u>\$ 32,083,337</u>	<u>\$ 30,144,532</u>

There were no securities pledged to secure public deposits or for other purposes required by law at September 30, 2008. 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 \$974,525 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, 2008 and December 31, 2007 that reflected an unrealized loss in value. These unrealized losses have been evaluated and are considered to be temporary impairments of the value of the issues. A summary of these securities as of September 30, 2008 and December 31, 2007 is as follows:

Description	September 30, 2008					
	Total		Less than 12 Months		12 Months or Greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Agencies	\$ 4,986,360	\$ (13,640)	\$ 4,986,360	\$ (13,640)	\$ -	\$ -
Mortgage backs	-	-	-	-	-	-
Corporate	9,431,048	(1,957,205)	9,431,048	(1,957,205)	-	-
Tax exempt municipals	3,159,862	(80,642)	1,435,597	(19,353)	1,724,265	(61,289)
Total Unrealized Loss Positions	<u>\$ 17,577,270</u>	<u>\$ (2,051,487)</u>	<u>\$ 15,853,005</u>	<u>\$ (1,990,198)</u>	<u>\$ 1,724,265</u>	<u>\$ (61,289)</u>

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

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

The securities identified above for September 30, 2008 with unrealized losses consist of eight corporate issues, two government agency issues, and fourteen 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.

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, 2008 and 2007:

	September 30,	
	2008	2007
	<u>2008</u>	<u>2007</u>
Balance, beginning of period	\$ 925,000	\$ 1,070,000
Provision for loan losses	210,000	50,000
Charge-offs	(154,113)	(254,984)
Recoveries of loans previously charged off	34,127	10,500
Balance, end of period	<u>\$ 1,015,014</u>	<u>\$ 875,516</u>
Allowance for loan losses to total loans	<u>0.90%</u>	<u>0.82%</u>

The following is a summary of information pertaining to impaired loans at September 30, 2008 and 2007:

	September 30,	
	2008	2007
	<u>2008</u>	<u>2007</u>
Impaired loans with a valuation allowance	\$ 1,599,879	\$ 1,010,275
Impaired loans without a valuation allowance	555,085	90,139
Total impaired loans	<u>\$ 2,154,964</u>	<u>\$ 1,100,414</u>
Valuation allowance related to impaired loans	<u>\$ 335,200</u>	<u>\$ 245,500</u>
Average investment in impaired loans	<u>\$ 1,294,676</u>	<u>\$ 1,195,858</u>
Interest income recognized	<u>\$ 104,587</u>	<u>\$ 128,692</u>

There were no non-accrual loans excluded from impaired loan disclosure under SFAS No. 114 at September 30, 2008 and 2007.

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.

	Nine Months Ended September 30,			
	2008		2007	
	Shares	Per Share	Shares	Per Share
	<u>Shares</u>	<u>Per Share</u>	<u>Shares</u>	<u>Per Share</u>
Basic & Diluted earnings per share	1,926,656	\$ 0.48	1,926,656	\$ 0.51

5. Fair Value Measurements

SFAS No. 157, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

- ❖ *Level 1* - inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- ❖ *Level 2* - inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- ❖ *Level 3* - inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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

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

Loans held for sale: At September 30, 2008, there were no loans held for sale.

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

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

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141(R), “Business Combinations” (SFAS 141(R)). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes the criteria for how an acquiring entity in a business combination recognizes the assets acquired and liabilities assumed in the transaction, establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed, and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. Acquisition related costs including finder's fees, advisory, legal, accounting valuation and other professional and consulting fees are required to be expensed as incurred. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008, and early implementation is not permitted. The Bank does not expect the implementation to have a material impact on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No.160, “Noncontrolling Interests in Consolidated Financial Statements” (SFAS 160). SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent’s ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. The Statement also establishes reporting requirements that provide sufficient disclosures to clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Bank does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, “Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Bank does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (SFAS 162). This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS 162 becomes effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411. The Bank does not expect the implementation of SFAS 162 to have a material impact on its consolidated financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) No. 157-2, “Effective Date of FASB Statement No. 157” (FSP 157-2). FSP 157-2 delays the effective date of SFAS 157, “Fair Value Measurements,” for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the FASB and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157. FSP 157-2 defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for items within the scope of this FSP. Examples of items to which the deferral would and would not apply are listed in the FSP. The Bank does not expect the implementation of FSP 157-2 to have a material impact on its consolidated financial statements.

In April 2008, the FASB issued FSP 142-3, “Determination of the Useful Life of Intangible Assets” (FSP 142-3). This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142, “Goodwill and Other Intangible Assets.” The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R, “Business Combinations,” and other U.S. generally accepted accounting principles. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. Early adoption is prohibited. The Bank does not expect the implementation of FSP 142-3 to have a material impact on its consolidated financial statements.

In May 2008, the FASB issued FSP APB 14-1, “Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)” (FSP APB 14-1). FSP APB 14-1 clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, “Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.” The FSP requires that issuers of such instruments should separately account for the liability (debt) and equity (conversion option) components in a manner that reflects the issuer’s nonconvertible debt borrowing rate. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those years. The Bank does not expect the implementation of FSP APB 14-1 to have a material impact on its consolidated financial statements.

In October 2008, the FASB issued FSP 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active” (FSP 157-3). FSP 157-3 clarifies the application of SFAS 157, “Fair Value Measurements,” in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP was effective upon issuance, including prior periods for which financial statements have not been issued.

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 2008 and 2007 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, 2008 and December 31, 2007

At the end of the third quarter, total assets were \$165.4 million, representing a \$4.2 million or 2.61% increase over the December 31, 2007 level of \$161.2 million. Total deposits amounted to \$138.8 million as of September 30, 2008, which represents a \$11.3 million or 8.86% increase from the \$127.5 million level as of December 31, 2007. On an annualized basis, deposits grew during the first three quarters at a rate of 11.82%. During the same period, total loans expanded by 4.86% or \$5.2 million to the September 30, 2008 balance of \$112.2 million. At September 30, 2008, the investment portfolio, including time deposits in other banks, was \$32.6 million, an 8.31% increase in comparison to the December 31, 2007 \$30.1 million level. While corporate debt holdings have experienced negative fair value adjustments over recent quarters, the portfolio contains no holding of preferred government agency sponsored stocks or debt obligations of corporations in default. The corporate issues held are investment grade and fair value impairments are believed temporary at the present time. Overnight federal funds sold decreased 60.53% from \$7.6 million on December 31, 2007 to \$3.0 million on September 30, 2008 as the Bank elected to retire certain Federal Home Loan Bank borrowings and reduce the overall cost of funds. Cumulatively, earning assets grew \$3.1 million for the first three quarters of 2008, or 2.86% on an annualized basis, and represent 89.36% of total assets.

The allowance for loan losses was \$1,015,000 as of September 30, 2008, or 0.90% of loans outstanding, compared to \$925,000 as of December 31, 2007 or 0.86% of outstanding loans. Charges to the Reserve account for loan losses amounted to \$154,000 as of September 30, 2008 or 0.11% of average outstanding loans for 2008. For the first nine months of 2007, charges to the reserve of \$255,000 were taken representing 0.23% of average loans outstanding for the period. Allocations to the reserve account of \$210,000 were provisioned for the nine months of 2008 compared to provision allocations of \$50,000 for the same period of 2007.

The Bank works diligently to maintain quality in its loan portfolio and has historically maintained an average delinquency ratio well below 1%. Loans past due more than thirty days (excluding impaired and nonaccrual loans) measured \$967,000 or 0.86% of total loans at September 30, 2008 as compared to December 31, 2007 delinquencies of \$364,000, or 0.34% 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, 2008, non-performing assets stood at \$2.2 million or 1.99% of quarter-end loans. This compared to non-performing assets of \$1.0 million, or 0.94%, of total loans outstanding for December 31, 2007.

Comparison of Results of Operations for the Nine months Ended September 30, 2008 and 2007

For the nine-month period ended September 30, 2008, the Bank reported earnings of \$918,000, a decrease of 6.33% when compared to \$980,000 through the first nine months of 2007. For the first three quarters of 2008 and 2007, earnings per basic and diluted share of \$0.48 and \$0.51, respectively, were recorded. Annualized returns on average assets and average equity for the first nine months of 2008 were 0.74% and 6.63%, respectively, compared to 0.85% and 7.46%, respectively, for the same period in 2007. Margins remain pressured from drastic rate reductions by the Federal Reserve over the past twelve months. The cost of funds for deposits is dropping as this segment cycles through rate resets. Margins strengthened during the third quarter as anticipated and further improvement is forecast for the last quarter of the year.

Net interest income. For the first nine months of 2008, net interest income increased to \$4,479,000 from \$4,352,000 in the comparable period in 2007. Average loans through the third quarter of 2008, when compared to the same period in 2007, grew to \$109.3 million from \$103.8 million, an increase of 5.30%. The average investment portfolio climbed from a 2007 nine-month average balance of \$27.6 million to a \$32.0 million average through the third quarter of 2008, or an increase of 15.94%. Average deposit growth has increased 12.37% or \$12.1 million to \$109.9 million over the same prior year period's average of \$97.8 million. The Bank's prime based loan portfolio yields decreased 23 basis points when comparing the first nine months of 2008 to that period in 2007 while the investment portfolio in the same period gained 49 basis points. Cumulatively, yields on earning assets decreased 21 basis points from a 2007 nine-month average of 7.07% to an average of 6.86% for the current year's same period. Volume growth in the bank's interest bearing deposit products coupled with the negative short-term effects resulting from the recent and rapid monetary policy changes have pressured the net interest margin downward by 14 basis points to 4.08%. This growth in liquidity prompted a \$6.0 million or 44.44% reduction in Federal Home Loan Bank borrowings during the second quarter. These once extremely attractive rates had begun adversely affecting margins due to the aforementioned rate cuts, and this move should help boost margins going forward. Moreover, the shorter-lived deposit rate cycle continues re-pricing at substantially lower rates and is already adding margin expansion as evidenced by a 20 basis point improvement over the prior quarter's level of 3.94%.

Noninterest income. Noninterest income, exclusive of securities transactions, rose 4.71% or \$56,000 during the first nine months of 2008 to \$1,246,000 when compared to \$1,190,000 for the same period in 2007. Service charges posted higher results with a \$25,000 or 4.07% increase when comparing the first nine months of 2008 to that of 2007. In comparing these same two periods, the mortgage originations department climbed \$54,000 or 18.75%. Other noninterest income decreased by \$24,000 to \$264,000 during the first nine months of 2008 in comparison to the \$288,000 level recorded through the third quarter on 2007. However, the prior year's level included gains of \$52,000 posted from the sale of a former branch office after its consolidation with newer offices nearby.

Noninterest expense. Noninterest expense increased \$317,000 or 7.62% to \$4,479,000 during the first three quarters of 2008 from \$4,162,000 for the same period in 2007. Separately within this category, salaries and benefits rose 5.70% or \$147,000 while occupancy and furniture & equipment expenses increased \$74,000 or 13.12%. Other operating expenses through September 30, 2008 grew \$96,000 or 9.43% to a level of \$1,114,000.

Provision for loan losses. Provisions for loan losses amounted to \$210,000 through September 30, 2008 as growth and charges taken in 2008 to the reserve permitted additional provisions being made. During the same period in 2007, \$50,000 was allocated in provisions to the reserve for loan losses.

Comparison of Results of Operations for the Three Months Ended September 30, 2008 and 2007

For the third quarter of 2008, the Bank posted earnings of \$305,000, only a slight decrease of 1.61% over the \$310,000 earnings reported for the 2007 third quarter, continuing to demonstrate a stabilizing earnings environment. Basic and diluted earnings per share of \$0.16 were reported for the three months ended September 30, 2008, equaling those of the prior year's results for the same period.

Net interest income. Net interest income increased to \$1,582,000 in the third quarter of 2008 from \$1,476,000 in the comparable period in 2007. Volume growth in the bank's interest bearing deposit products coupled with the negative short-term effects resulting from the recent and rapid monetary policy changes have added downward pressure on the net interest margin; however, the cost of funds has progressed through its current cycle resetting deposit rates significantly lower. Fixed rate asset yields have remained relatively stable despite a lower prime rate, and, with these two factors combined, margin improvement is anticipated over the next quarter.

Noninterest income. Noninterest income, exclusive of securities transactions, grew 7.44% or \$29,000 in the third quarter of 2008 to \$419,000 when compared to \$390,000 for the same period in 2007. Service charges posted higher results with a \$12,000 or 5.83% increase when comparing the third quarter of 2008 to the third quarter of 2007. The mortgage originations department experienced a \$13,000 or 13.13% increase in the category for the third quarter of 2008 when compared to the same period of 2007. Other noninterest products and services, including those of the insurance and investment departments, increased by \$4,000 over the \$85,000 level recorded in the third quarter of 2007.

Noninterest expense. Noninterest expense increased \$126,000 or 9.05% to \$1,519,000 during the third quarter 2008 from \$1,393,000 for the same period in 2007. Salaries and benefits rose 4.95% or \$43,000 while occupancy and furniture & equipment expenses increased \$32,000 or 16.58%. Other operating expenses for the third quarter of 2008 grew \$49,000 or 14.71% to a level of \$382,000.

Provision for loan losses. Provision for loan losses increased from \$30,000 in the third quarter of 2007 to \$50,000 in the same period in 2008. This increase is reflective of the prevailing economic state, charges taken during the current year, and assessment of the loan 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,					
	2008			2007		
	Average Balance	Income / Expense	Yield / ⁽⁴⁾ Rate	Average Balance	Income / Expense	Yield / ⁽⁴⁾ Rate
(Dollars in Thousands)						
Assets:						
Interest earning assets:						
Investment securities ⁽¹⁾	\$ 31,999	\$ 1,185	4.94%	\$ 27,588	\$ 920	4.45%
Interest-bearing balances with banks	1,847	58	4.19%	585	22	5.03%
Loans	109,316	6,281	7.67%	103,845	6,136	7.90%
Federal funds sold	5,091	91	2.39%	6,883	265	5.15%
Total interest earning assets	<u>148,253</u>	<u>7,615</u>	<u>6.86%</u>	<u>138,901</u>	<u>7,343</u>	<u>7.07%</u>
Non-interest earning assets:						
Cash and due from banks	4,503			3,703		
Premises and equipment	8,305			7,084		
Other assets	5,840			5,543		
Less: Allowance for loan losses	<u>(970)</u>			<u>(961)</u>		
	<u>17,678</u>			<u>15,369</u>		
	<u><u>\$165,931</u></u>			<u><u>\$154,270</u></u>		
Liabilities and Stockholders' Equity						
Interest bearing liabilities:						
Interest-bearing demand deposits	\$ 14,251	\$ 136	1.28%	\$ 9,744	\$ 26	0.36%
Money market deposit accounts	7,013	64	1.22%	6,879	97	1.89%
Savings accounts	11,833	53	0.60%	13,199	59	0.60%
Time deposits	76,765	2,425	4.22%	68,008	2,296	4.51%
Total interest-bearing deposits	<u>109,862</u>	<u>2,678</u>	<u>3.26%</u>	<u>97,830</u>	<u>2,478</u>	<u>3.39%</u>
Securities sold under repurchase agreements	182	4	2.94%	-	-	0.00%
Other borrowings	-	0	0.00%	-	-	0.00%
Total interest-bearing liabilities	<u>121,448</u>	<u>3,086</u>	<u>3.39%</u>	<u>111,714</u>	<u>2,969</u>	<u>3.55%</u>
Non-interest bearing liabilities:						
Demand deposits	24,459			23,706		
Other liabilities	<u>1,541</u>			<u>1,342</u>		
Total liabilities	<u>147,448</u>			<u>136,762</u>		
Shareholders' Equity	<u>18,483</u>			<u>17,508</u>		
Total Liabilities & Shareholders' Equity	<u><u>\$165,931</u></u>			<u><u>\$154,270</u></u>		
Interest Spread⁽²⁾						
			3.47%			3.52%
Net Interest Margin⁽³⁾						
		<u>\$ 4,529</u>	4.08%		<u>\$ 4,374</u>	4.21%

⁽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 at September 30, 2008 dipped to 26.81% compared to 29.26% reported as of December 31, 2007. 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, 2008 and December 31, 2007:

	Risk Based Capital Analysis		
	September 30, 2008	December 31, 2007	
	(Dollars in Thousands)		
Tier 1 Capital:			
Common stock	\$ 3,853	\$ 3,853	
Capital surplus	5,894	5,894	
Retained earnings	7,879	8,321	
Reverse: Unrealized (Gains)/Losses	1,280	(81)	
Total tier 1 capital	<u>18,906</u>	<u>17,987</u>	
Tier 2 Capital:			
Allowance for loan losses	<u>1,015</u>	<u>925</u>	
Tier 3 Capital:			
Deductions for investments in banking and finance subsidiaries	<u>(139)</u>	<u>(139)</u>	
Total Risk Based Capital	<u>\$ 19,782</u>	<u>\$ 18,773</u>	
Risk weighted assets	<u>\$ 131,323</u>	<u>\$ 115,914</u>	
Quarterly average assets	<u>\$ 163,912</u>	<u>\$ 158,577</u>	
	September 30, 2008	December 31, 2007	Regulatory Minimum
Capital Ratios:			
Tier 1 risk based capital ratio	14.40%	15.52%	4.00%
Total risk based capital ratio	15.06%	16.20%	8.00%
Leverage ratio	11.53%	11.34%	4.00%

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 2008 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 2007 Annual Report on Form 10-KSB, "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 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	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, 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 10, 2008

Richard M. Liles
President and Chief Executive Officer

Date: November 10, 2008

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 10th, 2008

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 10th, 2008

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

Richard M. Liles
President and Chief Executive Officer

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

Dated: November 10th, 2008