

# SOUTHERN COMMUNITY FINANCIAL CORP.

## FORM 10-K (Annual Report)

Filed 4/1/2005 For Period Ending 12/31/2004

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-KSB**  
**ANNUAL REPORT UNDER SECTION 13 OR 15(d)**  
**OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2004

Commission file number 0-50765

**SOUTHERN COMMUNITY FINANCIAL CORP.**  
(Name of small business issuer in its charter)

**Virginia**

(State or other jurisdiction of  
incorporation or organization)

**16-1694602**

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

**1231 Alverser Drive, P.O. Box 330, Midlothian, Virginia**

(Address of principal executive offices)

**23113**

(Zip Code)

**804-897-3900**

(Issuer's telephone number)

**Securities registered under Section 12(b) of the Exchange Act:**

None

**Securities registered under Section 12(g) of the Exchange Act:**

Common Stock, \$4.00 par value

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 for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

State issuer's revenues for its most recent fiscal year: \$9,409,000.

The aggregate market value of common stock held by non-affiliates of the registrant as of March 1, 2005 was approximately \$19,707,000.

The number of shares of common stock outstanding as of March 1, 2005 was 1,765,844.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the 2005 definitive Proxy Statement to be used in conjunction with the 2005 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-KSB.

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**Southern Community Financial Corp.  
Form 10-KSB**

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**PART I**  
**ITEM 1 – DESCRIPTION OF BUSINESS**

**General**

Southern Community Financial Corp. (the “Company”) is the holding company of and successor to Southern Community Bank & Trust (the “Bank”). Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction (the “Share Exchange”) pursuant to an Agreement and Plan of Reorganization, dated January 28, 2003, between the Company and the Bank (the “Agreement”). The Agreement was approved by the shareholders of the Bank at the annual meeting of shareholders held on April 22, 2003. Under the terms of the Agreement, the shares of the Bank’s common stock were exchanged for shares of the Company’s common stock, par value \$4.00 per share (“Common Stock”), on a one-for-one basis. As a result, the Bank became a wholly owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company. All references to the Company in this annual report for dates or periods prior to April 30, 2004 are references to the Bank.

The Company was organized under the laws of the Commonwealth of Virginia to engage in commercial and retail banking. The Company opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Company acquired or formed three wholly owned subsidiaries of the Bank, Community First Mortgage Corporation (“Community First”) a full service mortgage banking company, Chippenham Insurance Agency, Inc. (“Chippenham Insurance”) a full service property and casualty insurance agency, and Southern Community Services, Inc. (“Southern Community Services”) a financial services company.

We offer a wide range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, and commercial, real estate and consumer loans. We are a community-oriented and locally managed financial institution focusing on providing a high level of responsive and personalized services to our customers, delivered in the context of a strong direct relationship with our customers. We conduct our operations from our main office/corporate headquarters location in which we have an operating branch and four additional branch offices.

The Company was incorporated in January 2003.

**Business Strategy**

Our strategies include the following:

- *To be a full service financial services provider enabling us to establish and maintain relationships with our customers.*
- *To attract customers by providing the breadth of products offered by larger banks while maintaining the quick response and personal service of a community bank . We will continue to look for opportunities to expand our products and services. In our first five years of operation, we have established a diverse product line, including commercial, mortgage and consumer loans.*

- *To increase net income and return to shareholders through continued loan growth, while controlling the cost of our deposits and noninterest expenses .*
- *To expand our branch network to lower our cost of funds and diversify our loan portfolio with retail, consumer and commercial loans . We believe that branching will help us attract customers of financial institutions that have recently consolidated in our region who desire the personal services of a community bank. We plan to open two new branches in 2005 expanding our presence in Chesterfield County.*
- *To expand our capacity to generate noninterest income through the sale of mortgage loans . On June 30, 2003 we acquired Community First Mortgage Corporation, a full service mortgage banking company. The acquisition of Community First substantially increased our noninterest income during 2004.*
- *To continue to emphasize commercial banking products and services . Small-business commercial customers are a source of prime-based loans and fee income from cash management services, and low cost deposits which we need to fund our growth. We have been able to build a commercial business base because our staff of commercial bankers seeks opportunities to network within the local business community. Significant additional growth in this banking area will depend on expanding our lending staff.*
- *To target larger commercial customers . With the additional capital from our secondary stock offering in September 2002, our legal lending limit is approximately \$2,000,000. Our increased legal lending limit is helping us to accommodate the borrowing needs of our customers.*

Our officers, employees and the directors live and work in our market area. We believe that the existing and future banking market in our community represents an opportunity for locally owned and locally managed community banks. In view of the continuing trend in the financial services industry toward consolidation into larger, sometimes impersonal, statewide, regional and national institutions, the market exists for the personal and customized financial services that an independent, locally owned bank with local decision making can offer. With the flexibility of our smaller size and through an emphasis on relationship banking, including personal attention and service, we can be more responsive to the individual needs of our customers than our larger competitors. As a community oriented and locally managed institution, we make most of our loans in our community and can tailor our services to meet the banking and financial needs of our customers who live and do business in our market.

We provide customers with high quality, responsive and technologically advanced banking services. These services include loans that are priced on a deposit-based relationship, easy access to our decision makers, and quick and innovative action necessary to meet a customer's banking needs.

## **Location and Market Area**

We have focused our operations in Chesterfield County, Virginia, which, despite its potential for business development and population growth, has been underserved by community banks. Chesterfield's resources are very favorable for businesses seeking a profitable and stable environment. The county offers superb commercial and industrial sites, an educated work force, well-designed and developed infrastructure and a competitive tax structure. Chesterfield

has been awarded the U.S. Senate Gold Medallion for Productivity and Quality. The county has the highest bond rating from three rating agencies - Standard and Poors, Moody's and Fitch.

Our strategy is to build a strong community banking franchise and branch network in Chesterfield and then expand our franchise into other counties in the Richmond Metropolitan area. Both Chesterfield County and Henrico County have seen strong population growth in recent years, and the growth trends are expected to continue. According to the U.S. Census Bureau, the 2000 population of Chesterfield County was 259,903, compared to 209,274 in 1990. The number of households in Chesterfield County climbed from 73,441 in 1990 to 93,772 in 2000. The projected figures for 2010 are a population of 319,000 in 117,500 households. The 2000 population of Henrico County was 262,300 compared to 217,849 in 1990. The number of households in 2000 was 108,121 compared to 89,138 in 1990. The projected figures for Henrico County for 2010 are a population of 291,000 in 122,900 households. These population figures place Henrico and Chesterfield, respectively, as the largest two counties in central Virginia and the third and fourth largest counties in the state.

Residential growth in Chesterfield County is the strongest in the Richmond area. In 2003, Chesterfield issued 2,178 permits for new single-family homes, compared to 1,886 in Henrico County and 1,834 for the remainder of the Richmond Metro area. Developers continue to locate their planned communities in western Chesterfield County. The Board of Supervisors of Chesterfield County just recently approved four new residential subdivisions in which approximately 2,000 new single family residences are planned over the next two to three years. The Winterpock area of Chesterfield County is expected to see substantial growth over the next six years, with the Deer Run development nearing completion and subdivisions such as and Bayhill Point continuing their impressive growth. The primary road serving these growing subdivisions is Route 360, and all of these communities are within two miles of our Clover Hill branch. These three subdivisions alone accounted for 248 new homes in 2002 according to The Chesterfield County Residential Development Report prepared by the Chesterfield County Planning Department. And finally, the western section of Route 288, the circumferential highway around the Richmond Metropolitan area, was completed in 2004 and significantly improved access to and from Chesterfield County by the surrounding counties.

At December 31, 2004, we had five full service banking offices (including one in our main office), which were staffed by 20 full-time employees. Our senior staff averages more than 25 years of professional or banking experience. Our principal office, which houses our executive officers, loan department and mortgage banking subsidiary, Community First, was opened in November 2003 and is located at 1231 Alverser Drive, Midlothian, Virginia 23113. One of our branch facilities is located in this building. Our main telephone number is (804) 897-3900. Our four other branch offices are all located in Chesterfield County. We currently have approval from the Virginia State Corporation Commission for an additional branch to be located on property we already own on Robious Road in Chesterfield County. Each branch office has been strategically located to be convenient to business and retail customers in the growth sectors of Chesterfield County.

We are investigating several possible sites for additional branches. The opening of any additional banking offices will require prior regulatory approval, which takes into account a number of factors, including, among others, a determination that we have capital in an amount deemed sufficient to warrant additional expansion and a finding that the public interest will be served.

Prominent local newspapers, one regional newspaper, and a number of radio and television stations provide diverse media outlets. The broad exposure of television, print media and radio offers several opportunities to explore effective advertising and public relations avenues for Southern Community.

## **Banking Services**

We receive deposits, make consumer and commercial loans, and provide other services customarily offered by a commercial banking institution, such as business and personal checking and savings accounts, drive-up windows, and 24-hour automated teller machines. We have not yet applied for permission to establish a trust department and offer trust services. We are not a member of the Federal Reserve System. Our deposits are insured under the Federal Deposit Insurance Act to the limits provided thereunder.

We offer a full range of short-to-medium term commercial and personal loans. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements) and purchase of equipment and machinery. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education and personal investments. We also originate fixed and variable rate mortgage loans and real estate construction and acquisition loans. Fixed rate residential loans are usually sold in the secondary mortgage market.

Our lending activities are subject to a variety of lending limits imposed by state law. While differing limits apply in certain circumstances based on the type of loan or the nature of the borrower (including the borrower's relationship to the bank), in general, for loans that are not secured by readily marketable or other permissible collateral, we are subject to a loans-to-one borrower limit of an amount equal to 15% of our capital and surplus. We may voluntarily choose to impose a policy limit on loans to a single borrower that is less than the legal lending limit. We are a member of the Community Bankers' Bank and may participate out portions of loans when loan amounts exceed our legal lending limits or internal lending policies.

## **Lending Activities**

Our primary focus is on making loans to small businesses and consumers in our local market area. In addition, we also provide a wide range of real estate finance services. Our primary lending activities are principally directed to our market area.

*Loan Portfolio.* The net loan portfolio was \$134,162,000 at December 31, 2004, which compares to \$91,523,000 at December 31, 2003. The Company has enjoyed strong loan growth the last two years reflecting the strong economy in the market we serve. Loans grew by 85% in 2003 and by 47% in 2004. Our loan customers are generally located in the Richmond metropolitan area.

*Commercial Business Lending.* Our commercial business lending consists of lines of credit, revolving credit facilities, term loans, equipment loans, stand-by letters of credit and unsecured loans and continues to be one of the largest segments of our loan portfolio. Commercial loans are written for any business purpose including the financing of plant and equipment, carrying accounts receivable, general working capital, contract administration and acquisition activities. Our client base is diverse, and we do not have a concentration of loans in any specific industry segment. Commercial business loans are generally secured by accounts receivable, equipment and other collateral such as marketable securities, cash value of life insurance, and time deposits. Commercial business loans have a higher degree of risk than residential mortgage loans, but have higher yields. To manage these risks, we generally obtain appropriate collateral and personal guarantees from the borrower's principal owners and monitor the financial condition of business borrowers. The availability of funds for the repayment of commercial business loans may substantially depend on the success of the business itself. Further, the

collateral for commercial business loans may depreciate over time and cannot be appraised with as much precision as residential real estate. All commercial loans we make have recourse under the terms of a promissory note. At December 31, 2004, commercial loans totaled \$40,491,000, or 29.8% of the total loan portfolio.

*Commercial Real Estate Lending.* We finance commercial real estate for our clients and commercial real estate loans represent the largest segment of our loan portfolio. This segment of our loan portfolio has become the largest segment in 2004 due to the significant real estate opportunities in our market area. We generally will finance owner-occupied commercial real estate at an 80% loan-to-value ratio or less. In many cases our loan-to-value ratio is less than 80%, which provides us with a higher level of collateral security. Our underwriting policies and procedures focus on the borrower's ability to repay the loan as well as assessment of the underlying real estate. Risks inherent in managing a commercial real estate loan portfolio relate to sudden or gradual drops in property values as well as changes in the economic climate. We attempt to mitigate those risks by carefully underwriting loans of this type as well as following appropriate loan-to-value standards. Commercial real estate loans (generally owner occupied) at December 31, 2004 were \$45,121,000, or 33.2% of the total loan portfolio.

*Real Estate Construction Lending.* This segment of our loan portfolio is predominately residential in nature and comprised of loans with short duration, meaning maturities of twelve months or less. Residential houses under construction and the underlying land for which the loan was obtained secure the construction loans. Construction lending entails significant risks compared with residential mortgage lending. These risks involve larger loan balances concentrated with single borrowers with funds advanced upon the security of the land and home under construction, which is estimated prior to the completion of the home. Thus it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate these risks we generally limit loan amounts to 80% of appraised values on pre-sold homes and 75% on speculative homes, and obtain first lien positions on the property taken as security. Additionally, we offer real estate construction financing to individuals who have demonstrated the ability to obtain a permanent loan. At December 31, 2004, construction loans total \$30,870,000, or 22.7% of the total loan portfolio.

*Residential Mortgage Lending.* We make permanent residential mortgage loans for inclusion in the loan portfolio. We seek to retain in our portfolio variable rate loans secured by one-to-four-family residences. However, the majority of permanent residential loans are made by the Bank's subsidiary, Community First, which sells them to investors in the secondary mortgage market on a pre-sold basis. Given the low fixed rate residential loan market in recent years, this allows us to offer this service to our customers without retaining a significant low rate residential loan portfolio which would be detrimental to earnings as interest rates increase. We originate both conforming and non-conforming single-family loans.

Before we make a loan we evaluate both the borrower's ability to make principal and interest payments and the value of the property that will secure the loan. We make first mortgage loans in amounts of up to 95% of the appraised value of the underlying real estate. We retain some second mortgage loans secured by property in our market area, as long as the loan-to-value ratio combined with the first mortgage does not exceed 90%. For conventional loans in excess of 80% loan-to-value, private mortgage insurance is required.

Our current one-to-four-family residential adjustable rate mortgage loans have interest rates that adjust every 1, 3 and 5 years, generally in accordance with the rates on comparable U.S. Treasury bills. Our adjustable rate mortgage loans generally limit interest rate increases to 2% each rate adjustment period and have an established ceiling rate at the time the loans are made of up to 6% over the original interest rate. There are risks resulting from increased costs to a



borrower as a result of the periodic repricing mechanisms of these loans. Despite the benefits of adjustable rate mortgage loans to our asset/liability management, they pose additional risks, primarily because as interest rates rise, the underlying payments by the borrowers rise, increasing the potential for default. At the same time, the marketability of the underlying property may be adversely affected by higher interest rates. At December 31, 2004, \$15,395,000, or 11.3% of our loan portfolio, consisted of residential mortgage loans.

*Consumer Installment Lending.* We offer various types of secured and unsecured consumer loans. We make consumer loans primarily for personal, family or household purposes as a convenience to our customer base since these loans are not the primary focus of our lending activities. Our general guideline is that a consumer's total debt service should not exceed 40% of the consumer's gross income. Our underwriting standards for consumer loans include making a determination of the applicant's payment history on other debts and an assessment of his or her ability to meet existing obligations and payments on the proposed loan. The stability of an applicant's monthly income may be determined by verification of gross monthly income from primary employment and additionally from any verifiable secondary income. Consumer loans totaled \$4,130,000 at December 31, 2004, which was 3.0% of the total loan portfolio.

*Loan Commitments and Contingent Liabilities.* In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities which are disclosed in the footnotes of our annual financial statements, including commitments to extend credit. At December 31, 2004, undisbursed credit lines, standby letters of credit and commitments to extend credit totaled \$36,033,000.

*Credit Policies and Administration.* The Company has adopted a comprehensive lending policy, which includes stringent underwriting standards for all types of loans. Our lending staff follows pricing guidelines established periodically by our management team. In an effort to manage risk, all credit decisions in excess of the officers' lending authority must be approved prior to funding by a management loan committee and/or a board of directors-level loan committee. Any loans above \$1,000,000 require full board of directors approval. Management believes that it employs experienced lending officers, secures appropriate collateral and carefully monitors the financial conditions of our borrowers and the concentration of such loans in the portfolio.

In addition to the normal repayment risks, all loans in our portfolio are subject to the state of the economy and the related effects on the borrower and/or the real estate market. Generally, longer-term loans have periodic interest rate adjustments and/or call provisions. Our senior management monitors the loan portfolio closely to ensure that past due loans are minimized and that potential problem loans are swiftly dealt with. In addition to the internal business processes employed in the credit administration area, the Company retains an outside or independent credit review firm to review the loan portfolio. A detailed annual review is performed, with an interim update occurring at least once a year. Results of the report are used to validate our internal loan ratings and to provide independent commentary on specific loans and loan administration activities.

*Lending Limit.* As of December 31, 2004, our legal lending limit for loans to one borrower was approximately \$2,200,000. As part of our risk management strategy, we attempt to participate a portion of our larger loans to other financial institutions. This allows us to maintain customer relationships yet reduce credit exposure and stay within our legal lending limit.

## **Investments and Funding**

We balance our liquidity needs based on loan and deposit growth via the investment portfolio, purchased federal funds, and Federal Home Loan Bank advances. It is our goal to provide

adequate liquidity to support our loan growth. Should we have excess liquidity, investments are used to generate positive earnings. In the event deposit growth does not fully support our loan growth, a combination of investment sales, federal funds and Federal Home Loan Bank advances will be used to augment our funding position.

Our investment portfolio is actively monitored and is generally classified as "available for sale." Under such a classification, investment instruments may be sold as deemed appropriate by management. On a monthly basis, the investment portfolio is marked to market via equity as required by SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Additionally, we use the investment portfolio to balance our asset and liability position. We will invest in fixed rate or floating rate instruments as necessary to reduce our interest rate risk exposure.

For securities classified as available-for-sale securities or held-to-maturity, the Company will evaluate whether a decline in fair value below the amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings. There were no securities at December 31, 2004 where a decline in market value was considered other than temporary.

## **Competition**

We encounter strong competition from other local commercial banks, savings and loan associations, credit unions, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market mutual funds and other financial institutions. A number of these competitors are well-established. Competition for loans is keen, and pricing is important. Most of our competitors have substantially greater resources and higher lending limits than ours and offer certain services, such as extensive and established branch networks and trust services, which we do not provide at the present time. Deposit competition also is strong, and we may have to pay higher interest rates to attract deposits. Nationwide banking institutions and their branching have increased competition in our markets, and federal legislation adopted in 1999 allows non-banking companies, such as insurance and investment firms, to establish or acquire banks.

The greater Richmond metropolitan market has experienced several significant mergers or acquisitions involving all four regional banks formerly headquartered in central Virginia over the past fifteen years. Additionally, other larger banks from outside Virginia have acquired local banks. We believe that the Company can capitalize on the recent merger activity and attract customers from those who are dissatisfied with the recently acquired banks.

At June 30, 2004, the latest date such information is available from the FDIC, the Bank's deposit market share in Chesterfield County was 4.50%.

## **Effect of Adverse Economic Conditions**

Our business may be adversely affected by periods of economic slowdown or recession which may be accompanied by decreased demand for consumer credit and declining real estate values. Any material decline in real estate values could have a significant adverse effect on the operations of the Company as 67.2% of our loan portfolio is collateralized by real estate. Declines in real estate values can reduce projected cash flows from commercial properties and the ability of borrowers to use home equity to support borrowings and increase the loan-to-value ratios of loans previously made by us, thereby weakening collateral coverage and increasing the

possibility of a loss in the event of default. In addition, delinquencies, foreclosures and losses generally increase during economic slowdowns or recessions.

We anticipate the majority of our depositors will be located in and doing business in the local market and we will lend a substantial portion of our capital and deposits to individuals and business borrowers in this market area. Any factors adversely affecting the economy of this market could, in turn, adversely affect our performance.

## Regulation

We are subject to regulations of certain federal and state agencies and receive periodic examinations by those regulatory authorities. As a consequence of the extensive regulation of commercial banking activities, our business is susceptible to being affected by state and federal legislation and regulations.

**General.** The discussion below is only a summary of the principal laws and regulations that comprise the regulatory framework applicable to us. The descriptions of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, do not purport to be complete and are qualified in their entirety by reference to applicable laws and regulations. In recent years, regulatory compliance by financial institutions such as ours has placed a significant burden on us both in costs and employee time commitment.

**Bank Holding Company.** The Company is a bank holding company under the Federal Bank Holding Company Act of 1956, as amended, and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and Virginia State Corporation Commission ("SCC"). As a bank holding company, the Company is required to furnish to the Federal Reserve Board an annual report of its operations at the end of each fiscal year and to furnish such additional information as the Federal Reserve Board may require pursuant to the Bank Holding Company Act. The Federal Reserve Board, FDIC and SCC also may conduct examinations of the Company and/or its subsidiary bank.

The Gramm-Leach-Bliley Act of 1999 (the "Act") was enacted on November 12, 1999. The Act draws new lines between the types of activities that are financial in nature and permitted for banking organizations, and those activities that are commercial in nature and not permitted. The Act imposes Community Reinvestment requirements on financial service organizations that seek to qualify for the expanded powers to engage in broader financial activities and affiliations with financial companies that are permitted.

The Act creates a new form of financial organization called a financial holding company that may own banks, insurance companies and securities firms. A financial holding company is authorized to engage in any activity that is financial in nature, incidental to an activity that is financial in nature, or is a complimentary activity. These activities may include insurance, securities transactions, and traditional banking activities. The Act establishes a consultative and cooperative procedure between the Federal Reserve and the Secretary of the Treasury for purposes of determination as to the scope of activities permitted by the Act.

A bank holding company must satisfy special criteria to qualify for the expanded powers authorized by the Act, including the maintenance of a well-capitalized and well-managed status for all affiliate banks and a satisfactory community reinvestment rating.

**Bank Regulation.** As a Virginia state-chartered bank that is not a member of the Federal Reserve System, the Bank is subject to regulation, supervision and examination by the SCC's

Bureau of Financial Institutions (“BFI”). The Bank is also subject to regulation, supervision and examination by the FDIC. Federal law also governs the activities in which we may engage, the investments we may make and the aggregate amount of loans that may be granted to one borrower. Various consumer and compliance laws and regulations also affect our operations. Earnings are affected by general economic conditions, management policies and the legislative and governmental actions of various regulatory authorities, including those referred to above. The following description summarizes some of the laws to which we are subject. The BFI and the FDIC will conduct regular examinations, reviewing such matters as the adequacy of loan loss reserves, quality of loans and investments, management practices, compliance with laws, and other aspects of their operations. In addition to these regular examinations, we must furnish the FDIC with periodic reports containing a full and accurate statement of our affairs. Supervision, regulation and examination of banks by these agencies are intended primarily for the protection of depositors rather than shareholders.

**Insurance of Accounts, Assessments and Regulation by the FDIC.** Our deposits are insured by the FDIC up to the limits set forth under applicable law, currently \$100,000. Deposits are subject to the deposit insurance assessments of the Bank Insurance Fund (“BIF”) of the FDIC. The FDIC is authorized to prohibit any BIF-insured institution from engaging in any activity that the FDIC determines by regulation or order to pose a serious threat to the respective insurance fund. Also, the FDIC may initiate enforcement actions against banks, after first giving the institution’s primary regulatory authority an opportunity to take such action. The FDIC may terminate the deposit insurance of any depository institution if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed in writing by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If deposit insurance is terminated, the deposits at the institution at the time of termination, less subsequent withdrawals, shall continue to be insured for a period from six months to two years, as determined by the FDIC. We are aware of no existing circumstances that could result in termination of our deposit insurance.

**Capital.** The FDIC has issued risk-based and leverage capital guidelines applicable to banking organizations they supervise. Under the risk-based capital requirements, we are generally required to maintain a minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit), of 8%. At least half of the total capital is to be composed of common equity, retained earnings and qualifying perpetual preferred stock, less certain intangibles (“Tier 1 capital”). The remainder may consist of certain subordinated debt, certain hybrid capital instruments and other qualifying preferred stock and a limited amount of the loan loss allowance (“Tier 2 capital” and, together with Tier 1 capital, “total capital”). In addition, each of the Federal bank regulatory agencies has established minimum leverage capital ratio requirements for banking organizations. These requirements provide for a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets equal to 4% for banks and bank holding companies that meet certain specified criteria. All other banks and bank holding companies will generally be required to maintain a leverage ratio of at least 100 to 200 basis points above the stated minimum. The risk-based capital standards of the FDIC explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution’s ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution’s overall capital adequacy. The capital guidelines also provide that an institution’s exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a bank’s capital adequacy.

**Other Safety and Soundness Regulations.** There are a number of obligations and restrictions imposed on depository institutions by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insurance funds in the event the depository institution becomes in danger of default or is in default. The Federal banking agencies also have broad powers under current Federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution in question is well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized, as defined by the law. Federal regulatory authorities also have broad enforcement powers over us, including the power to impose fines and other civil and criminal penalties, and to appoint a receiver in order to conserve the assets of any such institution for the benefit of depositors and other creditors.

**Loan-to-One Borrower.** Under applicable laws and regulations the amount of loans and extensions of credit which may be extended by a bank to any one borrower, including related entities, generally may not exceed 15% of the unimpaired capital and unimpaired surplus of the institution. Loans in an amount equal to an additional 10% of unimpaired capital and unimpaired surplus also may be made to a borrower if the loans are fully secured by readily marketable securities. An institution's "unimpaired capital and unimpaired surplus" includes, among other things, the amount of its core capital and supplementary capital included in its total capital under Federal regulations.

**Community Reinvestment.** The requirements of the Community Reinvestment Act ("CRA") are applicable to Southern Community. The CRA imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those institutions. A financial institution's efforts in meeting community credit needs currently are evaluated as part of the examination process pursuant to 12 assessment factors. These factors also are considered in evaluating mergers, acquisitions and applications to open a branch or facility.

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

## **Employees**

As of December 31, 2004, the Company and its subsidiaries had a total of 61 full-time employees and 8 part-time employees. None of the Company's employees are covered by a collective bargaining agreement. The Company considers its relations with its employees to be good.

## **Dependence on Key Personnel**

Our growth and development to date have been largely dependent upon the services of Thomas W. Winfree, President and Chief Executive Officer, Jack M. Robeson, Senior Vice President/Lending, Raymond E. Sanders, Senior Vice President/Retail Banking, and C. Harril Whitehurst, Jr., Senior Vice President and Chief Financial Officer. The loss of the services for Messrs. Winfree, Robeson, Sanders or Whitehurst for any reason could have a material adverse effect on the Company.

## **Control by Certain Shareholders**

The Company has one shareholder who owns 9.45% of its outstanding Common Stock. As a group, the Board of Directors and the Company's Executive Officers control 19.67% of the outstanding Common Stock of the Company. Accordingly, such persons, if they were to act in concert, would not have majority control of the Bank and would not have the ability to approve certain fundamental corporate transactions or the election of the Board of Directors.

## **ITEM 2 – DESCRIPTION OF PROPERTY**

Our executive and administrative offices are located at 1232 Alverser Drive, Midlothian, Virginia. We opened this office in November 2003. This office also houses our mortgage banking company, Community First Mortgage Corporation, and one of our branch operations. The building, which we own and which has been substantially renovated to meet our needs, is a two-story brick structure consisting of approximately 8,200 square feet. The cost of this building, including renovations, amounted to \$1,046,000.

Our largest branch office is located at 13531 Midlothian Turnpike, Midlothian, Virginia. This was our initial office location and also housed our executive and administrative offices until the opening of the operations center on Alverser Drive. The building, which has been substantially renovated, is a two-story brick structure with a basement, consisting of approximately 3,500 square feet. It has six teller stations, three drive-up lanes and a drive-up ATM and night depository. Prior to December 31, 2002, this building was leased. It was purchased from our landlord on December 31, 2002 for \$1,713,000.

We have a branch office at 6736 Southshore Drive at Route 360 (Hull Street Road), in Chesterfield County. The building is a one-story brick structure consisting of approximately 2,400 square feet. The branch location was purchased in June 2002 from Branch Bank & Trust for \$1,384,000. It has four teller stations, two drive-up lanes and a drive-up ATM and night depository.

We opened a third branch location at 4221 West Hundred Road, Chester, Virginia in April 2003. The building is a one-story brick structure with a basement consisting of approximately 1,800 square feet. The branch is being leased for a term of five years commencing April 1, 2003 and ending March 31, 2008 for total lease payments of approximately \$186,000 over the life of the lease. We have renewal options for two five year periods subsequent to the initial term. It has four teller stations, one drive-up lane and a drive-up ATM and night depository.

We opened our fourth branch at 13521 Waterford Place, in Chesterfield County, in October 2004. Currently, the branch is temporarily housed in a mobile manufactured building, which we purchased for \$46,000 in April 2004, while a one-story brick structure consisting of approximately 2,500 square feet is being built. The branch is expected to cost \$533,000 (including land) and open in May 2005. It will have three teller stations, two drive-up lanes and a drive-up ATM and night depository.

Our properties are maintained in good operating condition and are suitable and adequate for our operational needs.

### **ITEM 3 – LEGAL PROCEEDINGS**

In the course of its operations, the Company may become a party to legal proceedings. There are no material pending legal proceedings to which the Company is a party or of which the property of the Company is subject.

### **ITEM 4 – SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

## PART II

### ITEM 5 – MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

#### Market Price of and Cash Dividends on the Company's Common Equity

Shares of the Company's Common Stock trades on the Nasdaq SmallCap Market under the symbol "SCBV". The high and low trade prices of shares of the Company's Common Stock for the periods indicated were as follows:

	<u>High</u>	<u>Low</u>
<b>2003:</b>		
1st quarter	\$8.06	\$7.60
2nd quarter	8.63	7.68
3rd quarter	9.24	8.15
4th quarter	12.83	8.90
<b>2004:</b>		
1st quarter	\$13.00	\$10.96
2nd quarter	12.96	11.00
3rd quarter	12.75	11.39
4th quarter	12.25	11.25

At March 1, 2005, there were approximately 1,055 holders of record of Common Stock.

The Company has not paid any dividends on its Common Stock. We intend to retain all of our earnings to finance the Company's operations and we do not anticipate paying cash dividends for the foreseeable future. Any decision made by the Board of Directors to declare dividends in the future will depend on the Company's future earnings, capital requirements, financial condition and other factors deemed relevant by the Board. Banking regulations limit the amount of cash dividends that may be paid without prior approval of the Bank's regulatory agencies. Such dividends are limited to the lesser of the Bank's retained earnings or the net income of the previous two years combined with the current year net income.

#### Transfer Agent and Registrar

Registrar and Transfer Company, 10 Commerce Drive, Cranford, New Jersey 07016-3572 (phone 908-497-2300) serves as our transfer agent and registrar.



## ITEM 6 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### General

The Company is the holding company of and successor to the Bank. Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction (the "Share Exchange") pursuant to an Agreement and Plan of Reorganization, dated January 28, 2003, between the Company and the Bank (the "Agreement"). The Agreement was approved by the shareholders of the Bank at the annual meeting of shareholders held on April 22, 2003. Under the terms of the Agreement, the shares of the Bank's common stock were exchanged for shares of the Company's common stock, par value \$4.00 per share ("Common Stock"), on a one-for-one basis. As a result, the Bank became a wholly owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company. All references to the Company in this annual report for dates or periods prior to April 30, 2004 are references to the Bank.

The Company was organized under the laws of the Commonwealth of Virginia to engage in commercial and retail banking. The Company opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Company acquired or formed three wholly owned subsidiaries of the Bank, Community First Mortgage Corporation ("Community First") a full service mortgage banking company, Chippenham Insurance Agency, Inc. ("Chippenham Insurance") a full service property and casualty insurance agency, and Southern Community Services, Inc. ("Southern Community Services") a financial services company.

We offer a wide range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, and commercial, real estate and consumer loans. We are a community-oriented and locally managed financial institution focusing on providing a high level of responsive and personalized services to our customers, delivered in the context of a strong direct relationship with our customers. We conduct our operations from our main office/corporate headquarters location and four branch offices.

The Company experienced record earnings of \$862,000 in 2004 as compared to earnings of \$69,000 in 2003 and a loss of \$(330,000) in 2002. This improvement in our earnings is a direct result of our growth. Loans and deposits, the primary sources of income and expense for the Company, increased from \$91,523,000 and \$96,323,000 at December 31, 2003 to \$134,162,000 and \$140,027,000 at December 31, 2004. These increases resulted in an increase in net interest income of \$1,757,000, from \$3,124,000 in 2003 to \$4,881,000 in 2004. The 2004 earnings were affected by two nonrecurring items. First, the Company wrote-off approximately \$118,000 related to goodwill associated with the purchase in 2003 of the insurance subsidiary of the Bank. Second, the Company recorded an income tax benefit of approximately \$339,000 related to the removal of the valuation allowance on its net deferred tax assets. The net effect of these two items increased 2004 results by \$221,000, or \$0.11 per fully diluted share.

Total assets increased to \$160,305,000 at December 31, 2004 from \$115,060,000 at December 31, 2003. The 39.3% increase in total assets during 2004 resulted from the growth of our business and customer base. Because we believe that interest rates will not increase significantly in 2005 and the local economy will remain healthy, we expect such growth to continue in 2005.

The following presents management's discussion and analysis of the financial condition of the Company at December 31, 2004 and 2003, and results of operations for the Company for the years ended December 31, 2004, 2003 and 2002. This discussion should be read in conjunction with the Company's audited Financial Statements and the notes thereto appearing elsewhere in this report.

## **Asset/Liability Management**

Management strives to manage the maturity or repricing match between assets and liabilities. The degree to which the Company is "mismatched" in its maturities is a primary measure of interest rate risk. In periods of stable interest rates, net interest income can be increased by financing higher yielding long-term mortgage loan assets with lower cost short-term deposits and borrowings. Although such a strategy may increase profits in the short run, it increases the risk of exposure to rising interest rates and can result in funding costs rising faster than asset yields. We expect to limit our interest rate risk by selling a majority of the fixed rate mortgage loans that we originate and retaining for the most part loans with adjustable rate features.

Contractual principal repayments of loans do not necessarily reflect the actual term of our loan portfolio. The average lives of mortgage loans are substantially less than their contractual terms because of loan prepayments and because of enforcement of due-on-sale clauses, which gives us the right to declare a loan immediately due and payable in the event, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. In addition, certain borrowers increase their equity in the security property by making payments in excess of those required under the terms of the mortgage.

## **Results of operations**

We recorded net income of \$862,000, or \$0.45 per fully diluted share, in 2004 compared to net income of \$69,000, or \$0.04 per fully diluted share, in 2003 and a net loss of \$(330,000), or \$(0.32) per fully diluted share, in 2002.

The significant improvement in our results of operations over the last two years is primarily attributable to two factors. First, net interest income increased significantly, from \$1,888,000 in 2002 to \$3,124,000 in 2003, a \$1,236,000 increase or 65.4%, to \$4,881,000 in 2004, a \$1,757,000 increase or 56.2%. These increases in net interest income are a result of significant increases in net loans, from \$49,956,000 at December 31, 2002 to \$91,523,000 at December 31, 2003, an increase of \$41,567,000 or 83.2%, to \$134,162,000 at December 31, 2004, an increase of \$42,639,000 or 46.6%. These increases in loans were funded by significant increases in deposits, from \$64,588,000 at December 31, 2002 to \$96,323,000 at December 31, 2003, an increase of \$31,735,000 or 49.1%, to \$140,027,000 at December 31, 2004, an increase of \$43,704,000 or 45.4%. The loan growth was also funded by a decrease in our investment securities available-for-sale from \$22,570,000 at December 31, 2002 to \$5,428,000 at December 31, 2004, a decrease of \$17,142,000 or 76.0% over the last two years. The interest rates on these securities were much lower than interest rates on the loans made also contributing to net interest income.

Second, the acquisition of Community First in 2003 resulted in a substantial increase in noninterest income from \$291,000 in 2002 to \$1,434,000 in 2003, an increase of \$1,143,000 or 393.2%, to \$1,759,000 in 2004, an increase of \$325,000 or 22.7%. These increases in net interest income and noninterest income were somewhat offset by increases in noninterest expense from \$2,196,000 in 2002 to \$4,090,000 in 2003, and to \$5,585,000 in 2004. These increases in noninterest expense resulted from the acquisition of two of the Bank's subsidiaries,

Community First and Chippenham Insurance, the addition of the Chester branch in 2003, and the growth in the Company overall.

Also contributing to the increase in net income in 2004 was the recognition of net deferred tax assets of \$377,000 due to the elimination of the valuation allowance. Management believes that it is more likely than not that the net deferred tax assets will be realized through future taxable income.

## **Interest Rate Risk**

Profitability may be directly affected by the levels of and fluctuations in interest rates, which affect our ability to earn a spread between interest received on loans and investments and the costs of deposits and borrowings. Our profitability is likely to be adversely affected during any period of unexpected or rapid changes in interest rates. For example, a substantial or sustained increase in interest rates could adversely affect our ability to originate loans and would reduce the value of loans held for sale.

The sale of fixed rate product is intended to protect the Company from precipitous changes in the general level of interest rates. The valuation of adjustable rate mortgage loans is not as directly dependent on the level of interest rates as is the value of fixed rate loans. Decisions to hold or sell adjustable rate mortgage loans are based on the need for such loans in our portfolio, which is influenced by the level of market interest rates and our asset/liability management strategy. As with our other investments, we regularly monitor the appropriateness of the level of adjustable rate mortgage loans in our portfolio and may decide from time to time to sell such loans and reinvest the proceeds in other adjustable rate investments.

## **Net interest income**

Net interest income is our primary source of earnings and represents the difference between interest and fees earned on interest-earning assets and the interest paid on interest-bearing liabilities. The level of net interest income is affected primarily by variations in the volume and mix of those assets and liabilities, as well as changes in interest rates when compared to previous periods of operation.

Net interest income for 2004, 2003 and 2002 was \$4,881,000, \$3,124,000 and \$1,888,000, respectively. The increases in net interest income of \$1,757,000, or 56.2%, in 2004 and \$1,236,000, or 65.4%, in 2003 are a direct result of increases in loans, from \$91,523,000 at December 31, 2003 to \$134,162,000 at December 31, 2004, a \$42,639,000, or 46.6%, increase, and from \$49,956,000 at December 31, 2002 to \$91,523,000 at December 31, 2003, a \$41,567,000, or 83.2%, increase. These increases in loans were funded primarily by increases in deposits. Additionally, our net interest margin has steadily improved over the last three years from 3.13% in 2002 to 3.65% in 2003 to 3.88% in 2004.

Average interest-earning assets in 2004 increased by \$40,294,000, or 47.1%, compared to 2003. The increase in interest-earning assets from 2003 to 2004 was due primarily to the growth of our loan portfolio. The average yield on interest-earning assets of 6.08% in 2004 was higher than the average yield of 5.99% in 2003. Previous to 2003, we had experienced a decline in average yield on interest-earning assets due in large part to actions by the Federal Reserve to reduce short-term interest rates in an effort to stimulate the national economy. During 2003, rates remained relatively flat. Many of our loans are indexed to short-term rates affected by the Federal Reserve's decisions, and, accordingly, as the Federal Reserve increased interest rates in 2004 the average yield on interest-earning assets increased.

Our interest-bearing liabilities in 2004 increased by \$37,836,000, or 50.2%, compared to 2003. The growth in those liabilities was due primarily to strong growth in deposits from an average of \$70,804,000 in 2003 to an average of \$108,137,000 in 2004, a \$37,333,000, or 52.7%, increase. The average cost of interest-bearing liabilities declined to 2.45% in 2004 from 2.66% in 2003. The principal reason for the decline in the liability costs was the reduction in the costs of certificates of deposit, which fell from an average of 3.10% in 2003 to 2.79% in 2004. Higher-rate promotional certificates of deposit we put on the books primarily in 2000 have been maturing the last two years, and most of the matured deposits were retained at significantly lower rates. We experienced a similar decline in the average cost of certificates of deposit in 2003 compared with 2002.

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. We have no tax exempt assets for the periods presented.

**Average Balance Sheets**  
**( In thousands )**

	Year Ended December 31, 2004			Year Ended December 31, 2003		
	Average Balance	Interest Income/ Expense	Annualized Yield Rate	Average Balance	Interest Income/ Expense	Annualized Yield Rate
Loans						
Commercial	\$ 37,945	\$ 2,214	5.83%	\$ 30,596	\$ 1,966	6.43%
Real estate - residential	14,674	926	6.31%	13,311	862	6.48%
Real estate - commercial	27,253	1,915	7.03%	9,999	741	7.41%
Real estate - construction	28,409	1,957	6.89%	14,566	972	6.67%
Consumer	3,548	252	7.10%	3,697	268	7.25%
Gross loans	111,829	7,264	6.50%	72,169	4,809	6.66%
Investment securities	5,474	213	3.89%	8,551	219	2.56%
Loans held for sale	1,536	84	5.47%	1,292	62	4.80%
Federal funds and other	7,048	89	1.26%	3,581	37	1.03%
Total interest earning assets	125,887	7,650	6.08%	85,593	5,127	5.99%
Allowance for loan losses	(1,290)			(958)		
Cash and due from banks	4,594			3,654		
Premises and equipment, net	6,108			4,815		
Other assets	1,659			1,471		
Total assets	<u>\$136,958</u>			<u>\$ 94,575</u>		
Interest bearing deposits						
Interest checking	\$ 5,434	\$ 51	0.94%	\$ 3,823	\$ 39	1.02%
Money market	20,721	302	1.46%	14,751	224	1.52%
Savings	3,930	44	1.12%	3,349	41	1.22%
Certificates	78,052	2,174	2.79%	48,881	1,513	3.10%
Total deposits	108,137	2,571	2.38%	70,804	1,817	2.57%
Borrowings	4,834	196	4.05%	4,381	184	4.20%
Federal funds purchased	172	2	1.16%	122	2	1.64%
Total interest bearing liabilities	113,143	2,769	2.45%	75,307	2,003	2.66%
Noninterest bearing deposits	9,401			5,431		
Other liabilities	384			398		
Total liabilities	122,928			81,136		
Equity capital	14,030			13,439		
Total liabilities and capital	<u>\$136,958</u>			<u>\$ 94,575</u>		
Net interest income before provision for loan losses		<u>\$ 4,881</u>			<u>\$ 3,124</u>	
Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities			<u>3.63%</u>			<u>3.33%</u>
Annualized net interest margin (net interest income expressed as percentage of average earning assets)			<u>3.88%</u>			<u>3.65%</u>

Interest income and interest expense are affected by changes in both average interest rates and average volumes of interest-earning assets and interest-bearing liabilities. The following table analyzes changes in net interest income attributable to changes in the volume of interest-sensitive assets and liabilities compared to changes in interest rates.

Nonaccrual loans are included in average loans outstanding. The changes in interest due to both rate and volume have been allocated to changes due to volume and changes due to rate in proportion to the relationship of the absolute dollar amounts of the changes in each.

**Rate/Volume Analysis  
(In thousands)**

	2004 vs. 2003 Increase (Decrease) Due to Changes in			2003 vs. 2002 Increase (Decrease) Due to Changes in		
	Volume	Rate	Total	Volume	Rate	Total
	<b>Interest income</b>					
Loans	\$2,661	\$(183)	\$2,478	\$2,143	\$(280)	\$1,863
Investment securities	17	(24)	(7)	(173)	(148)	(321)
Fed funds sold and other	42	10	52	(25)	(23)	(48)
Total interest income	<u>2,720</u>	<u>(197)</u>	<u>2,523</u>	<u>1,945</u>	<u>(451)</u>	<u>1,494</u>
<b>Interest expense</b>						
Deposits						
Interest checking	15	(3)	12	19	(19)	-
Money market accounts	87	(9)	78	13	(8)	5
Savings accounts	6	(3)	3	17	(38)	(21)
Certificates of deposit	794	(133)	661	311	(162)	149
Total deposits	<u>902</u>	<u>(148)</u>	<u>754</u>	<u>360</u>	<u>(227)</u>	<u>133</u>
FHLB Advances	-	-	-	110	(4)	106
Federal funds purchased	-	-	-	1	-	1
Other borrowings	12	-	12	18	-	18
Total interest expense	<u>914</u>	<u>(148)</u>	<u>766</u>	<u>489</u>	<u>(231)</u>	<u>258</u>
<b>Net interest income</b>	<u>\$1,806</u>	<u>\$ (49)</u>	<u>\$1,757</u>	<u>\$1,456</u>	<u>\$(220)</u>	<u>\$1,236</u>

**Provision for loan losses**

The provision for loan losses for 2004, 2003 and 2002 was \$533,000, \$399,000, and \$313,000, respectively. The 33.6% increase in 2004 and the 27.5% increase in 2003 were due to stronger loan growth in both years. Gross outstanding loans increased by \$42,942,000 in 2004 and by \$42,491,000 in 2003. The amount of the loan loss provision is determined by an evaluation of the level of loans outstanding, the level of non-performing loans, historical loan loss experience, delinquency trends, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions.

**Noninterest income**

Noninterest income has increased significantly over the last two years from \$291,000 in 2002 to \$1,434,000 in 2003 and to \$1,759,000 in 2004, an increase of \$1,468,000 over the two year period. This increase is directly attributable to the acquisition of the Bank's mortgage banking subsidiary, Community First. As a result of this acquisition, our gains on loan sales increased from \$96,000 in 2002 to \$818,000 in 2003 and to \$1,073,000 in 2004, a \$977,000 increase over the two year period.

## Noninterest expense

Noninterest expense for the year ended December 31, 2004 amounted to \$5,585,000, an increase of \$1,495,000, or 36.6%, from the \$4,090,000 recorded in 2003. Salaries and benefits represented the largest increase, increasing from \$2,225,000 in 2003 to \$3,108,000 in 2004, a \$883,000, or 39.7%, increase. This increase as well as other increases in noninterest expense were primarily attributable to the growth of the Bank, a full year of operating expense related to Community First, and the opening of two branches in 2004.

Noninterest expense for the year ended December 31, 2003 totaled \$4,090,000, an increase of \$1,894,000, or 86.2%, from the \$2,196,000 recorded in 2002. Again, salaries and benefits represented the largest increase, increasing by 119.6% in 2003 to \$2,225,000, compared to \$1,013,000 in 2002. This increase as well as other increases in noninterest expense were primarily attributable to the acquisition of Community First and the opening of the Chester branch in 2003.

## Income taxes

We recorded an income tax benefit of \$339,000 in 2004 as a result of removing the valuation allowance against net deferred tax assets. This valuation allowance had been established in prior years due to the Company's operating losses. We did not record any income tax expense in 2003 or 2002.

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Bank recorded a franchise tax expense of \$116,000, \$82,000 and \$84,000 for 2004, 2003 and 2002, respectively.

## Loans

The following table presents the composition of our loan portfolio at the dates indicated.

### Loan Portfolio, Net (in thousands)

	December 31, 2004		December 31, 2003	
	Amount	%	Amount	%
Commercial	\$40,491	29.8%	\$32,822	35.4%
Real estate – residential	15,395	11.3%	14,279	15.3%
Real estate – commercial	45,121	33.2%	16,500	17.7%
Real estate – construction	30,870	22.7%	25,627	27.5%
Consumer	4,130	3.0%	3,836	4.1%
Total loans	136,007	100.0%	93,064	100.0%
Less: unearned income, net	(331)		(404)	
Less: allowance for loan losses	(1,514)		(1,138)	
Total loans, net	<u>\$134,162</u>		<u>\$91,522</u>	

**Maturities of Selected Loans**  
**December 31, 2004**  
(In thousands)

	Within 1 Year	Fixed Rate			Variable Rate			Total Maturities
		1 to 5 Years	After 5Years	Total	1 to 5 Years	After 5Years	Total	
Commercial	\$25,435	\$4,782	\$4,447	\$9,229	\$5,827	\$ -	\$5,827	\$40,491
R/E Construction	21,350	270	7,415	7,685	1,835	-	1,835	30,870

**Allowance for loan losses**

The allowance for loan losses at December 31, 2004 was \$1,514,000, compared to \$1,138,000 at December 31, 2003 and \$755,000 at December 31, 2002. The ratio of the allowance for loan losses to gross loans was 1.12% at December 31, 2004, 1.23% at December 31, 2003, and 1.50% at December 31, 2002. The amount of the loan loss provision is determined by an evaluation of the level of loans outstanding, the level of non-performing loans, historical loan loss experience, delinquency trends, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions. We believe the amount of the allowance for loan losses at December 31, 2004 is adequate to absorb the losses that can reasonably be anticipated from the loan portfolio at that date.



The following table presents an analysis of the changes in the allowance for loan losses for the periods indicated.

**Analysis of Allowance for Loan Losses  
(In thousands)**

	Year Ended December 31,	
	2004	2003
Beginning balance	\$ 1,138	\$ 755
Provision for loan losses	533	399
Charge-offs		
Commercial	(89)	(55)
Consumer	(48)	-
Mortgage	(21)	-
	<u>(158)</u>	<u>(55)</u>
Recoveries	1	-
Acquisition of Community First	-	39
	<u>          </u>	<u>          </u>
Ending balance	<u>\$ 1,514</u>	<u>\$ 1,138</u>
Loans outstanding at end of year (1)	<u>\$ 135,676</u>	<u>\$ 92,660</u>
Ratio of allowance for loan losses as a percent of loans outstanding at end of year	<u>1.12%</u>	<u>1.23%</u>
Average loans outstanding for the year (1)	<u>\$ 111,829</u>	<u>\$ 72,169</u>
Ratio of net charge-offs to average loans outstanding for the year	<u>0.14%</u>	<u>0.08%</u>

(1) Loans are net of unearned income.

We have allocated the allowance for loan losses according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within each of the categories of loans. The allocation of the allowance as shown in the table below should not be interpreted as an indication that losses in future years will occur in the same proportions or that the allocation indicates future loss trends. Furthermore, the portion allocated to each loan category is not the total amount available for future losses that might occur within such categories since the total allowance is a general allowance applicable to the entire portfolio.

**Allocation of the Allowance for Loan Losses  
( In thousands )**

	December 31, 2004		December 31, 2003	
	Total	%	Total	%
Commercial	\$ 653	43.2%	\$ 571	50.2%
Real estate - residential	97	6.4%	71	6.2%
Real estate - commercial	474	31.3%	225	19.8%
Real estate - construction	205	13.5%	172	15.1%
Consumer	85	5.6%	99	8.7%
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total	<u>\$ 1,514</u>	<u>100.0%</u>	<u>\$ 1,138</u>	<u>100.0%</u>



## Asset quality

The following table summarizes asset quality information at the dates indicated:

	At December 30,	
	2004	2003
Nonaccrual loans	\$ 473	\$ 336
Restructured loans	-	-
Foreclosed properties	-	-
Total nonperforming assets	\$ 473	\$ 336
Loans past due 90 days and still accruing (not included in nonaccrual loans above)	\$ 1,134	\$ 654
Nonperforming assets to loans at end of year (1)	0.35%	0.36%
Allowance for loan losses to nonaccrual loans	320.1%	338.7%

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(1) Loans are net of unearned income.

Interest is accrued on outstanding loan principal balances, unless the Company considers collection to be doubtful. Commercial and unsecured consumer loans are designated as non-accrual when payment is delinquent 90 days or at the point which the Company considers collection doubtful, if earlier. Mortgage loans and most other types of consumer loans past due 90 days or more may remain on accrual status if management determines that concern over our ability to collect principal and interest is not significant. When loans are placed in non-accrual status, previously accrued and unpaid interest is reversed against interest income in the current period and interest is subsequently recognized only to the extent cash is received. Interest accruals are resumed on such loans only when in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

At December 31, 2004, the Company had seven loans totaling \$473,000 for which interest was no longer being accrued. These loans are considered impaired and have specific allowances for loan losses totaling \$108,000 at December 31, 2004. The gross interest income that would have been earned in 2004 if the loans classified as nonaccrual had been current in accordance with the original terms was \$60,000. Ten loans totaling \$1,134,000 at December 31, 2004 were past due 90 days or more and interest was still being accrued as such amounts were considered collectible.

## Investment portfolio

At December 31, 2004 and 2003, all of our securities were classified as available-for-sale. The following table presents the composition of our investment portfolio at the dates indicated.

### Investment Securities Available-for-Sale (Dollars in thousands)

	Par Value	Amortized Cost	Unrealized Gain (Loss)	Estimated Fair Value	Average Yield
<b>December 31, 2004</b>					
US Government Agencies					
Within one year	\$ 1,820	\$ 1,814	\$ (1)	\$ 1,813	2.13%
One to five years	500	513	(8)	505	2.97%
More than five years	2,500	2,500	(49)	2,451	2.82%
Total	<u>4,820</u>	<u>4,827</u>	<u>(58)</u>	<u>4,769</u>	<u>2.57%</u>
Mortgage-backed securities					
More than five years	450	453	10	463	3.62%
Total	<u>450</u>	<u>453</u>	<u>10</u>	<u>463</u>	<u>3.62%</u>
Other investments					
Within one year	146	146	-	146	5.50%
More than five years	50	50	-	50	3.92%
	<u>196</u>	<u>196</u>	<u>-</u>	<u>196</u>	<u>5.10%</u>
Total investment securities	<u>\$ 5,466</u>	<u>\$ 5,476</u>	<u>\$ (48)</u>	<u>\$ 5,428</u>	<u>2.75%</u>
<b>December 31, 2003</b>					
US Government Agencies					
Within one year	\$ 3,400	\$ 3,398	\$ (1)	\$ 3,397	1.93%
One to five years	1,100	1,138	(9)	1,129	3.85%
More than five years	2,750	2,756	(55)	2,701	5.24%
Total	<u>7,250</u>	<u>7,292</u>	<u>(65)</u>	<u>7,227</u>	<u>3.48%</u>
Mortgage-backed securities					
More than five years	1,316	1,333	14	1,347	4.06%
Total	<u>1,316</u>	<u>1,333</u>	<u>14</u>	<u>1,347</u>	<u>4.06%</u>
Other investments					
More than five years	50	50	-	50	3.92%
Total investment securities	<u>\$ 8,616</u>	<u>\$ 8,675</u>	<u>\$ (51)</u>	<u>\$ 8,624</u>	<u>3.57%</u>

## Deposits

The following table gives the composition of our deposits at the dates indicated.

	<b>Deposits</b> <i>(In thousands)</i>			
	December 31, 2004		December 31, 2003	
	Amount	%	Amount	%
Demand accounts	\$ 10,031	7.2%	\$ 7,522	7.8%
Interest checking accounts	6,453	4.6%	4,686	4.9%
Money market accounts	24,000	17.1%	20,570	21.4%
Savings accounts	4,438	3.2%	3,280	3.4%
Time deposits of \$100,000 and over	31,974	22.8%	19,276	20.0%
Other time deposits	63,131	45.1%	40,989	42.5%
<b>Total</b>	<b>\$ 140,027</b>	<b>100.0%</b>	<b>\$ 96,323</b>	<b>100.0%</b>

Total deposits increased by 45.4% in 2004 and by 49.1% in 2003.

The variety of deposit accounts offered by the Company has allowed us to be competitive in obtaining funds and has allowed us to respond with flexibility to, although not to eliminate, the threat of disintermediation (the flow of funds away from depository institutions such as banking institutions into direct investment vehicles such as government and corporate securities). Our ability to attract and retain deposits, and our cost of funds, has been, and will continue to be, significantly affected by money market conditions.

The following table is a schedule of average balances and average rates paid for each deposit category for the periods presented:

Account Type	<b>Average Deposits and Rates Paid</b> <i>(In thousands)</i>			
	Year Ended December 31,			
	2004		2003	
	Amount	Rate	Amount	Rate
Noninterest-bearing demand accounts	\$ 9,401	-	\$ 5,425	-
Interest-bearing deposits				
Interest checking accounts	5,434	0.94%	3,829	1.02%
Money market accounts	20,721	1.46%	14,751	1.52%
Savings accounts	3,930	1.12%	3,349	1.22%
Time deposits of \$100,000 and over	25,857	2.63%	15,846	2.83%
Other time deposits	52,195	2.86%	33,035	3.22%
<b>Total interest-bearing deposits</b>	<b>108,137</b>	<b>2.38%</b>	<b>70,810</b>	<b>2.57%</b>
<b>Total average deposits</b>	<b>\$117,538</b>		<b>\$ 76,235</b>	

The following table is a schedule of maturities for time deposits of \$100,000 or more at the dates indicated.

**Maturities of Time Deposits of \$100,000 or More**  
**( In thousands )**

	As of December 31,	
	2004	2003
Due within three months	\$ 5,685	\$ 3,628
Due after three months through six months	6,649	4,623
Due after six months through twelve months	6,966	3,034
Over twelve months	12,674	7,991
	<u>\$ 31,974</u>	<u>\$ 19,276</u>

## **Borrowings**

We utilize borrowings to supplement deposits when they are available at a lower overall cost to us or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank (“FHLB”) of Atlanta, the Bank is required to own capital stock in the FHLB and is authorized to apply for borrowings from the FHLB. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses to which the advances may be put, as well as on the size of the advances and repayment provisions. Borrowings from the FHLB were \$4,000,000 at December 31, 2004 and 2003. The FHLB advances are secured by the pledge of residential mortgage loans, U.S. Government agency securities and our FHLB stock.

Federal funds purchased represent unsecured borrowings from other banks and generally mature daily. We did not have any purchased federal funds at December 31, 2004 or 2003.

## **Contractual obligations and other commitments**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve elements of credit risk and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contractual amounts of these instruments reflect the extent of the Company’s involvement in particular classes of financial instruments.

The Company’s exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and letters of credit written is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Unless noted otherwise, the Company does not require collateral or other security to support financial instruments with credit risk.

Commitments to extend credit are agreements to lend to a customer as long as there is no

violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being completely drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The following table summarizes our contractual cash obligations and commitments, including maturing certificates of deposit, as of December 31, 2004 and the effect such obligations may have on liquidity and cash flows in future periods.

**Contractual Obligations**  
*(Dollars in thousands)*

	Less Than One Year	1-3 Years	3-5 Years	Over 5 Years	Total
Leased property	\$ 54	\$ 85	\$ 10	\$ -	\$ 149
Time deposits (1)	51,973	26,830	16,302	-	95,105
FHLB advances	-	2,000	2,000	-	4,000
Other borrowings	835	-	-	-	835
Undisbursed credit lines	29,355	-	-	-	29,355
Commitments to extend credit	3,151	-	-	-	3,151
Standby letters of credit	3,527	-	-	-	3,527
	<u>\$ 88,895</u>	<u>\$28,915</u>	<u>\$ 18,312</u>	<u>\$ -</u>	<u>\$136,122</u>

(1) We expect to retain maturing deposits or replace maturing amounts with comparable time deposits based on current market rates.

**Capital resources**

Stockholders' equity at December 31, 2004 was \$14,985,000, compared to \$13,590,000 at December 31, 2003 and \$13,469,000 at December 31, 2002. The \$1,395,000 increase in equity during 2004 was due primarily to the net income for the year of \$862,000 and proceeds from the issuance of common stock of \$515,000. The \$121,000 increase in equity during 2003 was due to the net income for the year of \$69,000, the proceeds from the issuance of common stock of \$112,000, reduced by the \$(61,000) decrease in the net unrealized value of securities available-for-sale.

The following table presents the composition of regulatory capital and the capital ratios at the dates indicated.

**Analysis of Capital**  
**( In thousands )**

	As of December 31,	
	2004	2003
<b>Tier 1 capital</b>		
Common stock	\$ 7,047	\$ 6,844
Additional paid-in capital	8,616	8,304
Accumulated deficit	(646)	(1,507)
Total equity	15,017	13,641
Less: goodwill	(689)	(934)
Total Tier 1 capital	14,328	12,707
<b>Tier 2 capital</b>		
Allowance for loan losses	1,514	1,138
Total Tier 2 capital	1,514	1,138
Total risk-based capital	15,842	13,845
Risk-weighted assets	\$ 153,020	\$ 99,643
<b>Capital ratios</b>		
Tier 1 capital to risk-weighted assets	9.4%	12.8%
Total capital to risk-weighted assets	10.4%	13.9%
Leverage ratio (Tier 1 capital to average assets)	9.4%	11.4%
Equity to total assets	9.3%	11.8%

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, under capitalized, significantly under capitalized, and critically under capitalized. The Bank meets the criteria to be categorized as a “well capitalized” institution as of December 31, 2004. The “well capitalized” classification permits financial institutions to minimize the cost of FDIC insurance assessments by being charged a lesser rate than those that do not meet this definition.

**Liquidity**

Liquidity provides us with the ability to meet normal deposit withdrawals, while also providing for the credit needs of customers. We are committed to maintaining liquidity at a level sufficient to protect depositors, provide for reasonable growth, and fully comply with all regulatory requirements.

At December 31, 2004, cash, cash equivalents and investment securities available-for-sale totaled \$14,027,000, or 8.8% of total assets.



At December 31, 2004, we had commitments to originate \$36,033,000 of loans. Fixed commitments to incur capital expenditures were less than \$25,000 at December 31, 2004. Certificates of deposit scheduled to mature in the 12-month period ending December 31, 2004 total \$51,804,000. We believe that a significant portion of such deposits will remain with us. We further believe that loan repayments and other sources of funds will be adequate to meet our foreseeable short-term and long-term liquidity needs.

## **Interest rate sensitivity**

An important element of asset/liability management is the monitoring of our sensitivity to interest rate movements. In order to measure the effects of interest rates on our net interest income, management takes into consideration the expected cash flows from the securities and loan portfolios and the expected magnitude of the repricing of specific asset and liability categories. We evaluate interest sensitivity risk and then formulate guidelines to manage this risk based on management's outlook regarding the economy, forecasted interest rate movements and other business factors. Our goal is to maximize and stabilize the net interest margin by limiting exposure to interest rate changes.

Contractual principal repayments of loans do not necessarily reflect the actual term of our loan portfolio. The average lives of mortgage loans are substantially less than their contractual terms because of loan prepayments and because of enforcement of due-on-sale clauses, which gives us the right to declare a loan immediately due and payable in the event, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. In addition, certain borrowers increase their equity in the security property by making payments in excess of those required under the terms of the mortgage.

The sale of fixed rate loans is intended to protect us from precipitous changes in the general level of interest rates. The valuation of adjustable rate mortgage loans is not as directly dependent on the level of interest rates as is the value of fixed rate loans. As with other investments, we regularly monitor the appropriateness of the level of adjustable rate mortgage loans in our portfolio and may decide from time to time to sell such loans and reinvest the proceeds in other adjustable rate investments.

The data in the following table reflects repricing or expected maturities of various assets and liabilities at December 31, 2004. The gap analysis represents the difference between interest-sensitive assets and liabilities in a specific time interval. Interest sensitivity gap analysis presents a position that existed at one particular point in time, and assumes that assets and liabilities with similar repricing characteristics will reprice at the same time and to the same degree.

**Interest Rate Sensitivity GAP Analysis**  
**December 31, 2004**  
*( In thousands )*

	Within 3 Months	3 to 6 Months	6 to 12 Months	13 to 36 Months	More than 36 Months	Total
<b>Interest Rate Sensitive Assets</b>						
Loans (1)						
Fixed rate	\$ 1,510	\$ 801	\$ 1,700	\$ 1,971	\$ 3,642	\$ 9,624
Variable rate	87,617	2,208	4,625	15,483	16,450	126,383
Investment securities	1,814	-	-	506	3,108	5,428
Loans held for sale	2,867	-	-	-	-	2,867
Federal funds sold	4,958	-	-	-	-	4,958
	<u>98,766</u>	<u>3,009</u>	<u>6,325</u>	<u>17,960</u>	<u>23,200</u>	<u>149,260</u>
Total rate sensitive assets	<u>98,766</u>	<u>101,775</u>	<u>108,100</u>	<u>126,060</u>	<u>149,260</u>	
Cumulative rate sensitive assets						
<b>Interest Rate Sensitive Liabilities</b>						
Interest checking (2)	-	-	-	6,453	-	6,453
Money market accounts	24,001	-	-	-	-	24,001
Savings (2)	-	-	-	4,438	-	4,438
Certificates of deposit	16,074	15,830	20,069	26,830	16,302	95,105
FHLB advances	-	-	-	-	4,000	4,000
Other borrowings	835	-	-	-	-	835
	<u>40,910</u>	<u>15,830</u>	<u>20,069</u>	<u>37,721</u>	<u>20,302</u>	<u>134,832</u>
Total rate sensitive liabilities	<u>40,910</u>	<u>15,830</u>	<u>20,069</u>	<u>37,721</u>	<u>20,302</u>	<u>134,832</u>
Cumulative rate sensitive liabilities						
	<u>40,910</u>	<u>56,740</u>	<u>76,809</u>	<u>114,530</u>	<u>134,832</u>	
Rate sensitivity gap for period	<u>\$ 57,856</u>	<u>\$(12,821)</u>	<u>\$(13,744)</u>	<u>\$(19,761)</u>	<u>\$ 2,898</u>	<u>\$ 14,428</u>
Cumulative rate sensitivity gap	<u>\$ 57,856</u>	<u>\$ 45,035</u>	<u>\$ 31,291</u>	<u>\$ 11,530</u>	<u>\$ 14,428</u>	
Ratio of cumulative gap to total assets	35.9%	27.9%	19.4%	7.2%	8.9%	
Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities	241.4%	179.4%	140.7%	110.1%	110.7%	
Ratio of cumulative gap to cumulative rate sensitive assets	58.6%	44.2%	28.9%	9.1%	9.7%	

(1) Includes nonaccrual loans of approximately \$472,700, which are spread throughout the categories.

(2) Management believes that interest checking and savings accounts are generally not sensitive to changes in interest rates and therefore has placed such deposits in the "13 to 36 months" category.

At December 31, 2004, our assets that reprice within one year exceeded liabilities that reprice within one year by \$31,291,000 and therefore we were in an asset-sensitive position. A positive gap can adversely affect earnings in periods of falling interest rates. This positive position is due primarily to our adjustable rate loan portfolio.

## Critical accounting policies

The financial condition and results of operations presented in the financial statements, accompanying notes to the financial statements and management's discussion and analysis are, to a large degree, dependent upon the Company's accounting policies. The selection and application of these accounting policies involve judgments, estimates, and uncertainties that are susceptible to change.

Presented below is discussion of those accounting policies that management believes are the most important accounting policies to the portrayal and understanding of our financial condition and results of operations. These critical accounting policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial condition or results of operations is a reasonable likelihood. See also Note 1 of the Notes to Consolidated Financial Statements.

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan. We maintain policies and procedures that address the systems of controls over the following areas of maintenance of the allowance: the systematic methodology used to determine the appropriate level of the allowance to provide assurance they are maintained in accordance with accounting principles generally accepted in the United States of America; the accounting policies for loan charge-offs and recoveries; the assessment and measurement of impairment in the loan and lease portfolio; and the loan grading system.

We evaluate various loans individually for impairment as required by Statement of Financial Accounting Standards (SFAS) 114, *Accounting by Creditors for Impairment of a Loan*, and SFAS 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*. Loans evaluated individually for impairment include non-performing loans, such as loans on non-accrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment. If a loan evaluated individually is not impaired, then the loan is assessed for impairment under SFAS 5, *Accounting for Contingencies*, with a group of loans that have similar characteristics.

For loans without individual measures of impairment, we make estimates of losses for groups of loans as required by SFAS 5. Loans are grouped by similar characteristics, including the type of loan, the assigned loan classification and the general collateral type. A loss rate reflecting the expected loss inherent in a group of loans is derived based upon estimates of default rates for a given loan grade, the predominant collateral type for the group and the terms of the loan. The resulting estimate of losses for groups of loans is adjusted for relevant environmental factors and other conditions of the portfolio of loans and leases, including: borrower and industry concentrations; levels and trends in delinquencies, charge-offs and recoveries; changes in underwriting standards and risk selection; level of experience, ability and depth of lending management; and national and local economic conditions.

The amount of estimated impairment for individually evaluated loans and groups of loans is added together for a total estimate of loans and lease losses. This estimate of losses is compared to our allowance for loan and lease losses as of the evaluation date and, if the estimate of losses is greater than the allowance, an additional provision to the allowance would be made. If the estimate of losses is less than the allowance, the degree to which the allowance exceeds the estimate is evaluated to determine whether the allowance falls outside a range of estimates. If the estimate of losses is below the range of reasonable estimates, the

allowance would be reduced by way of a credit to the provision for loan losses. We recognize the inherent imprecision in estimates of losses due to various uncertainties and variability related to the factors used, and therefore a reasonable range around the estimate of losses is derived and used to ascertain whether the allowance is too high. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the Financial Statements.

## **Forward-looking statements**

Certain information contained in this discussion may include “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are generally identified by phrases such as “we expect,” “we believe” or words of similar import. Such forward-looking statements involve known and unknown risks including, but not limited to, the following factors:

- the ability to successfully manage the Company’s growth or implement its growth strategies if it is unable to identify attractive markets, locations or opportunities to expand in the future;
- maintaining capital levels adequate to support the Company’s growth;
- reliance on the Company’s management team, including its ability to attract and retain key personnel;
- interest rate fluctuations;
- risk inherent in making loans such as repayment risks and fluctuating collateral values;
- the ability to continue to attract low cost core deposits to fund asset growth;
- changes in laws and regulations applicable to us;
- changes in general economic and business conditions;
- competition within and from outside the banking industry;
- new products and services in the banking industry;
- problems with our technology; and
- changing trends in customer profiles and behavior.

Although we believe that our expectations with respect to the forward-looking statements are based upon reliable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements.

## **New accounting standards**

In December 2003, the FASB issued Statement of Position 03-3, “Accounting for Certain Loans or Debt Securities Acquired in a Transfer”. This SOP, among other things, no longer allows financial institutions to record an allowance for loan losses, related to credit quality, when they purchase loans, including through a purchase business acquisition. The SOP is effective, on a prospective basis, for loans acquired in fiscal years beginning after December 31, 2004. We do not expect the adoption of SOP 03-3 to have an effect on our financial statements.

In January 2003, the FASB’s emerging issues task force issued statement 03-1 “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments”. The statement provides guidance in determining when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss.

The guidance also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The adoption of EITF 03-1 did not have a material impact on the Company's results of operations, financial position or cash flows.

In April 2003, the FASB issued Statement No. 149, "FAS 149" Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. The adoption of FAS 149 did not have a material impact on the Company's results of operations, financial position or cash flows.

In December 2003, the FASB issued FIN No. 46R, "Consolidation of Variable Interest Entities," an interpretation of Accounting Research Bulletin No. 51. FIN No. 46R requires that variable interest entities be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or is entitled to receive a majority of the entity's residual returns or both. FIN 46R also requires disclosure about variable interest entities that companies are not required to consolidate but in which a company has a significant variable interest. The consolidation requirements must be adopted no later than the beginning of the first fiscal year or interim period beginning after March 15, 2004. The adoption of FIN No. 46R is not expected to have a material impact on the Company's results of operations, financial position or cash flows.

SFAS No. 123 (Revised 2004), "Share-Based Payment," issued in December 2004, is a revision of FASB Statement 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. The Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123 (Revised 2004) requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. This statement is effective as of the beginning of the annual reporting period that begins after December 15, 2005. Although the Company has not completed its assessment, it does not believe the impact on the consolidated financial position or results of operations will be material.

### **Impact of inflation and changing prices and seasonality**

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

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

## ITEM 7 – FINANCIAL STATEMENTS

### Audited Financial Statements

The following 2004 Financial Statements of Southern Community Financial Corp. are included after the signature pages:

	<u>Page</u>
- Report of Independent Registered Public Accounting Firm	42
- Consolidated Statements of Financial Condition	43
- Consolidated Statements of Operations	44
- Consolidated Statements of Stockholders' Equity	45
- Consolidated Statements of Cash Flows	46
- Notes to Consolidated Financial Statements	47

## ITEM 8 – CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## ITEM 8A – CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings with the Securities and Exchange Commission.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company's last fiscal quarter that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## ITEM 8B – OTHER INFORMATION

None.

## **PART III**

### **ITEM 9 – DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 9 is contained in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

### **ITEM 10 – EXECUTIVE COMPENSATION**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 10 is contained in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

### **ITEM 11 – SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 11 is contained in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

### **ITEM 12 – CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 12 is contained in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

## ITEM 13 – EXHIBITS

<u>Exhibit Number</u>	<u>Description</u>
3.1	Articles of Incorporation of Southern Community Financial Corp., incorporated by reference to Exhibit 3.1 of the Current Report on Form 8-K dated April 30, 2004.
3.2	Bylaws of Southern Community Financial Corp., incorporated by reference to Exhibit 3.2 of the Current Report on Form 8-K dated April 30, 2004.
10.1	Incentive Plan.
10.2	Organizational Investors Warrant Plan.
10.3	Shareholder Loan Referral Warrant Plan.
10.4	Executive Employment Agreement, effective as of April 1, 2001, between Thomas W. Winfree and Southern Community Bank & Trust.
10.5	Form of Incentive Stock Option Agreement.
10.6	Form of Non-Employee Director Non-Qualified Stock Option Agreement.
21	Subsidiaries of Southern Community Financial Corp.
31.1	Section 302 Certification by Chief Executive Officer.
31.2	Section 302 Certification by Chief Financial Officer.
32	Section 906 Certification.



## ITEM 14 – PRINCIPAL ACCOUNTANT FEES AND SERVICES

Pursuant to General Instruction E(3) of Form 10-KSB, the information required to be disclosed in this Item 14 is contained in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

## SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

### SOUTHERN COMMUNITY FINANCIAL CORP.

Date: March 21, 2005

By: /s/ Thomas W. Winfree  
Thomas W. Winfree  
President and Chief Executive Officer

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

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Thomas W. Winfree</u> Thomas W. Winfree	President and Chief Executive Officer and Director (Principal Executive Officer)	March 21, 2005
<u>/s/ C. Harril Whitehurst, Jr.</u> C. Harril Whitehurst, Jr.	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 21, 2005
<u>/s/ R. T. Avery, III</u> R.T. Avery, III	Director	March 21, 2005
<u>/s/ Donald J. Balzer, Jr.</u> Donald J. Balzer, Jr.	Director	March 21, 2005
<u>/s/ Craig D. Bell</u> Craig D. Bell	Director	March 21, 2005
<u>/s/ William B. Chandler</u> William B. Chandler	Director	March 21, 2005
<u>/s/ Kent E. Engelke</u> Kent E. Engelke	Director	March 21, 2005

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ R. Calvert Esleeck, Jr.</u> R. Calvert Esleeck, Jr.	Director	March 21, 2005
<u>/s/ Dean Patrick</u> Dean Patrick	Director	March 21, 2005
<u>/s/ George R. Whittemore</u> George R. Whittemore	Director	March 21, 2005
<u>/s/ Michael L. Toalson</u> Michael L. Toalson	Director	March 21, 2005

Report of Registered Public Accounting Firm

Board of Directors  
Southern Community Financial Corp.  
Midlothian, Virginia

We have audited the accompanying consolidated statements of financial condition of Southern Community Financial Corp. and Subsidiary as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2004. These consolidated financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Southern Community Financial Corp. and Subsidiary as of December 31, 2004 and 2003, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

Richmond, Virginia  
February 7, 2005

**Southern Community Financial Corp. and Subsidiary**  
**Consolidated Statements of Financial Condition**  
**December 31, 2004 and 2003**

	2004	2003
<b>Assets</b>		
Cash and due from banks	\$ 3,641,535	\$ 3,547,608
Federal funds sold	4,957,872	2,016,833
Investment securities available for sale	5,427,604	8,623,803
Loans held for sale	2,867,084	1,502,997
Loans		
Outstandings	136,006,900	93,064,168
Allowance for loan losses	(1,514,029)	(1,137,794)
Unearned income	(330,578)	(403,867)
Loans, net	<u>134,162,293</u>	<u>91,522,507</u>
Premises and equipment, net	6,214,573	6,075,786
Accrued interest receivable	610,866	391,658
Goodwill	689,108	934,354
Other assets	<u>1,733,939</u>	<u>443,957</u>
	<u>\$160,304,874</u>	<u>\$115,059,503</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Deposits	\$140,027,386	\$ 96,322,607
Federal Home Loan Bank advances	4,000,000	4,000,000
Other borrowings	835,079	804,197
Accrued interest payable	175,154	114,177
Other liabilities	282,096	228,832
Commitments and contingencies	-	-
Total liabilities	<u>145,319,715</u>	<u>101,469,813</u>
<b>Stockholders' Equity</b>		
Preferred stock, \$1 par value - 1,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, \$4 par value - 3,000,000 shares authorized; 1,761,744 shares issued and outstanding at December 31, 2004, 1,710,994 shares issued and outstanding at December 31, 2003,	7,046,976	6,843,976
Additional paid-in capital	8,615,748	8,303,810
Accumulated other comprehensive income (loss)	(31,798)	(50,786)
Accumulated deficit	(645,767)	(1,507,310)
Total stockholders' equity	<u>14,985,159</u>	<u>13,589,690</u>
	<u>\$160,304,874</u>	<u>\$115,059,503</u>

See accompanying notes to consolidated financial statements.

**Southern Community Financial Corp. and Subsidiary**  
**Consolidated Statements of Operations**  
**Years Ended December 31, 2004, 2003 and 2002**

	2004	2003	2002
<b>Interest income</b>			
Loans	\$ 7,348,033	\$ 4,870,572	\$ 3,008,117
Investment securities	213,027	219,561	539,677
Federal funds sold and other	88,507	36,992	85,510
Total interest income	<u>7,649,567</u>	<u>5,127,125</u>	<u>3,633,304</u>
<b>Interest expense</b>			
Deposits	2,571,166	1,817,087	1,684,372
Borrowed funds	197,675	186,110	60,510
Total interest expense	<u>2,768,841</u>	<u>2,003,197</u>	<u>1,744,882</u>
<b>Net interest income</b>	4,880,726	3,123,928	1,888,422
Provision for loan losses	532,630	399,000	313,000
Net interest income after provision for loan losses	<u>4,348,096</u>	<u>2,724,928</u>	<u>1,575,422</u>
<b>Noninterest income</b>			
Service charges and fees	525,140	601,502	157,045
Gain (loss) on securities, net	(26,370)	(69,555)	(20,930)
Gain on sale of loans	1,072,708	818,390	96,353
Other operating income	187,930	83,736	58,283
Total noninterest income	<u>1,759,408</u>	<u>1,434,073</u>	<u>290,751</u>
<b>Noninterest expense</b>			
Salaries and benefits	3,108,032	2,225,006	1,013,441
Occupancy	302,339	251,509	225,509
Equipment	449,519	345,587	235,237
Supplies	188,737	207,106	123,441
Professional and outside services	664,487	524,446	277,704
Advertising and marketing	145,615	128,216	105,054
Other operating expense	726,541	408,306	216,113
Total noninterest expense	<u>5,585,270</u>	<u>4,090,176</u>	<u>2,196,499</u>
Net income (loss) before income taxes	522,234	68,825	(330,326)
Income tax (expense) benefit	339,309	-	-
<b>Net income (loss)</b>	<u>\$ 861,543</u>	<u>\$ 68,825</u>	<u>\$ (330,326)</u>
<b>Earnings (loss) per share, basic</b>	<u>\$ 0.50</u>	<u>\$ 0.04</u>	<u>\$ (0.32)</u>
<b>Earnings (loss) per share, diluted</b>	<u>\$ 0.45</u>	<u>\$ 0.04</u>	<u>\$ (0.32)</u>

See accompanying notes to consolidated financial statements.

**Southern Community Financial Corp. and Subsidiary**  
**Consolidated Statements of Stockholders' Equity**  
**Years Ended December 31, 2004, 2003, and 2002**

	Number of Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (loss)	Total
<b>Balance, December 31, 2001</b>	880,094	\$3,520,376	\$5,190,854	\$(1,245,809)	\$ (315,622)	\$ 7,149,799
Issuance of common stock	817,200	3,268,800	3,055,471	-	-	6,324,271
Net loss	-	-	-	(330,326)	-	(330,326)
Change in unrealized gain (loss) on securities available for sale	-	-	-	-	325,711	325,711
Total comprehensive income (loss)	-	-	-	(330,326)	325,711	(4,615)
<b>Balance, December 31, 2002</b>	1,697,294	6,789,176	8,246,325	(1,576,135)	10,089	13,469,455
Issuance of common stock	13,700	54,800	57,485	-	-	112,285
Net income	-	-	-	68,825	-	68,825
Change in unrealized gain (loss) on securities available for sale	-	-	-	-	(60,875)	(60,875)
Total comprehensive income	-	-	-	68,825	(60,875)	7,950
<b>Balance, December 31, 2003</b>	1,710,994	6,843,976	8,303,810	(1,507,310)	(50,786)	13,589,690
Issuance of common stock	50,750	203,000	311,938	-	-	514,938
Net income	-	-	-	861,543	-	861,543
Change in unrealized gain (loss) on securities available for sale	-	-	-	-	18,988	18,988
Total comprehensive income	-	-	-	861,543	18,988	880,531
<b>Balance, December 31, 2004</b>	<u>1,761,744</u>	<u>\$7,046,976</u>	<u>\$8,615,748</u>	<u>\$ (645,767)</u>	<u>\$ (31,798)</u>	<u>\$ 14,985,159</u>

*See accompanying notes to consolidated financial statements.*

**Southern Community Financial Corp. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
**Years Ended December 31, 2004, 2003 and 2002**

	2004	2003	2002
<b>Cash Flows from Operating Activities</b>			
Net income (loss)	\$ 861,543	\$ 68,825	\$ (330,326)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	336,184	264,168	182,496
Provision for loan losses	532,630	399,000	313,000
Gain on sale of loans	(1,072,708)	(818,390)	(96,353)
Loss on securities	26,370	69,555	20,930
Proceeds from sale of mortgage loans	45,447,941	37,653,942	-
Origination of mortgage loans for sale	(45,739,320)	(32,714,461)	-
Mortgage loans purchased	-	(5,740,531)	-
Amortization of premiums and accretion of discounts on securities, net	12,629	231,652	(2,317)
Proceeds from sale of insurance business	127,140	-	-
Write-off of goodwill	118,106	-	-
(Increase) decrease in interest receivable	(219,208)	(63,084)	29,418
Increase in other assets	(1,273,746)	(68,517)	(136,035)
Increase in interest payable	60,977	26,795	11,360
Increase in other liabilities	53,264	78,952	57,950
Net cash provided by (used in) operating activities	<u>(728,198)</u>	<u>(612,094)</u>	<u>50,123</u>
<b>Cash Flows from Investing Activities</b>			
Purchases of available for sale securities	(5,956,329)	(20,638,053)	(84,144,501)
Maturities of available for sale securities	9,116,281	34,222,208	65,755,317
Sales of available for sale securities	-	-	13,980,886
Loans originated	(43,172,416)	(42,209,223)	19,734,588)
Purchase of business	-	(934,354)	-
Purchases of premises and equipment	(474,971)	(2,453,048)	(3,281,941)
Net cash used in investing activities	<u>(40,487,435)</u>	<u>(32,012,470)</u>	<u>(27,424,827)</u>
<b>Cash Flows from Financing Activities</b>			
Issuance of common stock	514,938	112,285	6,324,271
Net increase in deposits	43,704,779	31,735,094	22,958,140
Federal Home Loan Bank borrowings	-	2,000,000	2,000,000
Net decrease in federal funds purchased	-	-	(1,710,000)
Net increase in other borrowings	30,882	804,197	-
Net cash provided by financing activities	<u>44,250,599</u>	<u>34,651,576</u>	<u>29,572,411</u>
Net increase (decrease) in cash and cash equivalents	3,034,966	2,027,012	2,197,707
Cash and cash equivalents, beginning of year	<u>5,564,441</u>	<u>3,537,429</u>	<u>1,339,722</u>
Cash and cash equivalents, end of year	<u>\$ 8,599,407</u>	<u>\$ 5,564,441</u>	<u>\$ 3,537,429</u>

See accompanying notes to consolidated financial statements.



**Southern Community Financial Corp. and Subsidiary**  
**Notes to Consolidated Financial Statements**  
**Years Ended December 31, 2004, 2003 and 2002**

**Note 1. Summary of Significant Accounting Policies**

The accounting and reporting policies of Southern Community Financial Corp. and subsidiary (the "Company") conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. The following is a description of the more significant of those policies:

**Business**

The Company is the holding company of and successor to Southern Community Bank & Trust (the "Bank"). Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction (the "Share Exchange") pursuant to an Agreement and Plan of Reorganization, dated January 28, 2003, between the Company and the Bank (the "Agreement"). The Agreement was approved by the shareholders of the Bank at the annual meeting of shareholders held on April 22, 2003. Under the terms of the Agreement, the shares of the Bank's common stock were exchanged for shares of the Company's common stock, par value \$4.00 per share ("Common Stock"), on a one-for-one basis. As a result, the Bank became a wholly owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company. All references to the Company in this annual report for dates or periods prior to April 30, 2004 are references to the Bank.

The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Bank acquired or formed three wholly owned subsidiaries, Community First Mortgage Corporation ("Community First") a full service mortgage banking company, Chippenham Insurance Agency, Inc. ("Chippenham Insurance") a full service property and casualty insurance agency, and Southern Community Services, Inc. ("Southern Community Services") a financial services company. Through these subsidiaries, the Bank provides a broad array of financial services to its customers.

The Company is subject to intense competition from existing bank holding companies, commercial banks and savings banks which have been in business for many years and have established customer bases. Competition also comes from a variety of other non-bank businesses that offer financial services. Many of these competitors operate in the same geographic market where the Company operates, are well-known with long-standing relationships with businesses and individuals in the communities, and are substantially larger with greater resources than the Company.

The Bank is also subject to regulations of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities. As a consequence of the extensive regulation of commercial banking activities, the Bank's business is susceptible to being affected by state and federal legislation and regulations.

The majority of the Company's real estate loans are collateralized by properties in markets in the Richmond, Virginia metropolitan area. Accordingly, the ultimate collectibility of those loans

collateralized by real estate is particularly susceptible to changes in market conditions in the Richmond area.

### **Basis of Presentation and Consolidation**

The consolidated financial statements include the accounts of the Company, the Bank and the Bank's subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

### **Use of estimates**

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the statements of financial condition and revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

### **Investment securities**

At the time of purchase, debt securities are classified into the following categories: held-to-maturity, available-for-sale or trading. Debt securities that the Company has both the positive intent and ability to hold to maturity are classified as held-to-maturity. Held-to-maturity securities are stated at amortized cost adjusted for amortization of premiums and accretion of discounts on purchase using a method that approximates the effective interest method. Investments classified as trading or available-for-sale are stated at fair market value. Changes in fair value of trading investments are included in current earnings while changes in fair value of available-for-sale investments are excluded from current earnings and reported, net of taxes, as a separate component of stockholders' equity. Presently, the Company does not maintain a portfolio of trading securities.

A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. No such declines have occurred.

Interest income is recognized when earned. Realized gains and losses for securities classified as available-for-sale and held-to-maturity are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

### **Loans held for sale**

The Company, through the Bank's mortgage banking subsidiary Community First, originates residential mortgage loans for sale in the secondary market. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an individual loan basis as determined by outstanding commitments from investors. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. Loans held for sale at December 31, 2004 amounted to \$2,867,084, the book value of which approximates their market values.

### **Rate lock commitments**

The Company, through the Bank's mortgage banking subsidiary Community First, enters into commitments to originate residential mortgage loans in which the interest rate on the loan is determined prior to funding, termed rate lock commitments. Such rate lock commitments on

mortgage loans to be sold in the secondary market are considered to be derivatives and must be accounted for as such. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 30 to 120 days. The Company protects itself from changes in interest rates during this period by requiring a firm purchase agreement from a permanent investor before a loan can be closed. As a result, the Company is not exposed to losses nor will it realize gains or losses related to its rate lock commitments due to changes in interest rates.

## **Loans**

Loans are stated at the principal amount outstanding, net of unearned income. Loan origination fees and certain direct loan origination costs are deferred and amortized to interest income over the life of the loan as an adjustment to the loan's yield over the term of the loan.

Interest is accrued on outstanding principal balances, unless the Company considers collection to be doubtful. Commercial and unsecured consumer loans are designated as non-accrual when payment is delinquent 90 days or at the point which the Company considers collection doubtful, if earlier. Mortgage loans and most other types of consumer loans past due 90 days or more may remain on accrual status if management determines that concern over our ability to collect principal and interest is not significant. When loans are placed in non-accrual status, previously accrued and unpaid interest is reversed against interest income in the current period and interest is subsequently recognized only to the extent cash is received. Interest accruals are resumed on such loans only when in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

## **Allowance for loan losses**

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can reasonably be anticipated. The allowance is increased by provisions charged to operations and reduced by net charge-offs. Loan performance is reviewed regularly by loan officers and senior management. Management believes the allowance for loan losses is adequate to absorb losses in the loan portfolio.

The allowance for loan losses is established by charges to operations based on management's evaluation of loans, economic conditions and other factors considered necessary to maintain the allowance at a level adequate to absorb possible losses. When collateral is considered in determining potential losses, fair value is based upon recent appraisals and evaluations of other factors. The allowance for loan losses is based on estimates and ultimate losses may vary from the current estimates. These estimates are reviewed periodically and adjusted as necessary. In addition, the Bank's regulatory agencies, as an integral part of their examination process, periodically review the allowance for possible loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments of information available to them at the time of their examination.

In addition, the Company evaluates its loans for impairment. A loan is considered to be impaired when it is probable that the Company will be unable to collect all principal and interest amounts according to the contractual terms of the loan agreement. The entire loan portfolio is regularly reviewed by management to identify impaired loans. Such review includes the maintenance of a current classified and criticized loan list and the regular reporting of delinquent loans to management.

The allowance for loan losses related to loans identified as impaired is primarily based on the excess of the loan's current outstanding principal balance over the estimated fair market value

of the related collateral. For impaired loans that are not collateral dependent, the allowance for loan losses is recorded at the amount by which the outstanding recorded principal balance exceeds the current best estimate of the future cash flows on the loan, discounted at the loan's effective interest rate.

### **Premises and equipment**

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation of buildings and improvements is computed using the straight-line method over the estimated useful lives of the assets of 39 years. Depreciation of equipment is computed using the straight-line method over the estimated useful lives of the assets ranging from 3 to 7 years. Amortization of premises (leasehold improvements) is computed using the straight-line method over the term of the lease or estimated lives of the improvements, whichever is shorter.

### **Goodwill**

Goodwill, which represents the excess of purchase price over fair value of net assets acquired, is evaluated at least annually for impairment by comparing its fair value with its recorded amount and is written down when appropriate. Projected net operating cash flows are compared to the carrying amount of the goodwill recorded and if the estimated net operating cash flows are less than the carrying amount, a loss is recognized to reduce the carrying amount to fair value.

Subsequent to December 31, 2004, the Company entered into an agreement to sell the insurance business of Chippenham Insurance. When the Company acquired Chippenham Insurance in 2003, it recorded goodwill of \$245,246. As a result of the sale, the Company recognized a loss of \$118,106 representing the difference between the expected proceeds from the sale and the carrying value of the goodwill. The expected proceeds from the sale of \$127,140 are included in other assets.

### **Income taxes**

Deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The effect on recorded deferred income taxes of a change in tax laws or rates is recognized in income in the period that includes the enactment date. To the extent that available evidence about the future raises doubt about the realization of a deferred income tax asset, a valuation allowance is established. The primary temporary differences are the allowance for loan losses and depreciation and amortization.

### **Consolidated statements of cash flows**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, due from banks (including cash items in process of collection), interest-bearing deposits with banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods. Cash flows from loans originated by the Bank and deposits are reported net. The Bank paid interest of \$2,708,000, \$1,976,000, and \$1,734,000 in 2004, 2003, and 2002, respectively. No income taxes were paid in 2003, 2002 and 2001.

### **Comprehensive income**

SFAS 130, *Reporting Comprehensive Income*, established standards for reporting and display of comprehensive income, its components and accumulated balances. Comprehensive income

is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. Among other disclosures, SFAS 130 requires that all items that are required to be recognized under current accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements.

### Earnings (loss) per common share

Basic earnings (loss) per common share is computed by dividing the net earnings (loss) by the weighted-average number of common shares outstanding during the period, which totaled 1,724,832, 1,698,064 and 1,088,186 during 2004, 2003 and 2002, respectively. Diluted earnings (loss) per share reflects the potential dilution of securities that could share in the net earnings (loss) of the Company. Outstanding options and warrants to purchase Common Stock (see Note 12) were considered in the computation of diluted earnings (loss) per share for the years presented. For the year ended December 31, 2004, the weighted average number of common shares on a fully diluted basis totaled 1,927,004. Outstanding options and warrants to purchase Common Stock were not included in the computation of diluted earnings (loss) per share for the years ended December 31, 2003 and 2002, as their effect would be anti-dilutive.

### Stock incentive plan

The Bank has a stock incentive plan which is more fully described in Note 12. The Bank applies Accounting Principles Board Opinion 25 in accounting for stock options granted to employees and directors pursuant to the plan. Had compensation expense been determined based upon the fair value of the awards at the grant date and consistent with the method under SFAS 123, the Bank's net income (loss) and net income (loss) per share for the years indicated would have been the pro forma amounts indicated in the following table:

	Year Ended December 31,		
	2004	2003	2002
Net income (loss) as reported	\$ 861,543	\$ 68,825	\$ (330,326)
Options expense	(88,000)	(133,000)	(119,000)
Pro forma net income (loss)	<u>\$ 773,543</u>	<u>\$ (64,175)</u>	<u>\$ (449,326)</u>
Net (income) loss per share			
Basic - as reported	<u>\$ 0.50</u>	<u>\$ 0.04</u>	<u>\$ (0.32)</u>
Basic - pro forma	<u>\$ 0.45</u>	<u>\$ (0.04)</u>	<u>\$ (0.41)</u>
Diluted - as reported	<u>\$ 0.45</u>	<u>\$ 0.04</u>	<u>\$ (0.32)</u>
Diluted - pro forma	<u>\$ 0.40</u>	<u>\$ (0.04)</u>	<u>\$ (0.41)</u>

The fair value of each option granted is estimated on the date of grant using the Black-Sholes option pricing model with the following assumptions used for grants for the years indicated:

	Year Ended December 31,		
	2004	2003	2002
Risk-free interest rate	4%	5%	5%
Dividend yield	0%	0%	0%
Expected weighted average term	7years	7years	7 years
Volatility	25%	35%	50%

### **Fair values of financial instruments**

The Bank uses the following methods and assumptions in estimating fair values of financial instruments (see Note 13):

*Cash and cash equivalents* – The carrying amount of cash and cash equivalents approximates fair value.

*Investment securities* – The fair value of investment securities held-to-maturity and available-for-sale is estimated based on bid quotations received from independent pricing services. The carrying amount of other investments approximates fair value.

*Loans* – For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. For all other loans, fair values are calculated by discounting the contractual cash flows using estimated market discount rates which reflect the credit and interest rate risk inherent in the loans, or by using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

*Deposits* – The fair value of deposits with no stated maturity, such as demand, interest checking and money market, and savings accounts, is equal to the amount payable on demand at year-end. The fair value of certificates of deposit is based on the discounted value of contractual cash flows using the rates currently offered for deposits of similar remaining maturities.

*Borrowings* – The fair value of FHLB borrowings is based on the discounted value of contractual cash flows using the rates currently offered for borrowings of similar remaining maturities. The carrying amounts of federal funds purchased approximate their fair values. Other borrowings are short-term in nature and the carrying amounts approximate fair value.

*Accrued interest* – The carrying amounts of accrued interest receivable and payable approximate fair value.

*Off-balance-sheet instruments* – The fair value of off-balance-sheet lending commitments is equal to the amount of commitments outstanding at December 31, 2004. This is based on the fact that the Bank generally does not offer lending commitments or standby letters of credit to its customers for long periods, and therefore, the underlying rates of the commitments approximate market rates.

## **New accounting pronouncements**

In December 2003, the FASB issued Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer". This SOP, among other things, no longer allows financial institutions to record an allowance for loan losses, related to credit quality, when they purchase loans, including through a purchase business acquisition. The SOP is effective, on a prospective basis, for loans acquired in fiscal years beginning after December 31, 2004. We do not expect the adoption of SOP 03-3 to have an effect on our financial statements.

In January 2003, the FASB's emerging issues task force issued statement 03-1 "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments". The statement provides guidance in determining when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The guidance also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The adoption of EITF 03-1 did not have a material impact on the Company's results of operations, financial position or cash flows.

In April 2003, the FASB issued Statement No. 149, "FAS 149" Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. The adoption of FAS 149 did not have a material impact on the Company's results of operations, financial position or cash flows.

In December 2003, the FASB issued FIN No. 46R, "Consolidation of Variable Interest Entities," an interpretation of Accounting Research Bulletin No. 51. FIN No. 46R requires that variable interest entities be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or is entitled to receive a majority of the entity's residual returns or both. FIN 46R also requires disclosure about variable interest entities that companies are not required to consolidate but in which a company has a significant variable interest. The consolidation requirements must be adopted no later than the beginning of the first fiscal year or interim period beginning after March 15, 2004. The adoption of FIN No. 46R is not expected to have a material impact on the Company's results of operations, financial position or cash flows.

SFAS No. 123 (Revised 2004), "Share-Based Payment," issued in December 2004, is a revision of FASB Statement 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. The Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123 (Revised 2004) requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. This statement is effective as of the beginning of the annual reporting period that begins after December 15, 2005. Although the Company has

not completed its assessment, it does not believe the impact on the consolidated financial position or results of operations will be material.

## **Reclassifications**

Certain amounts in the financial statements for 2003 and 2002 have been reclassified to conform to classifications adopted in 2004.

**Note 2. Investment securities available-for-sale**

The amortized cost and estimated fair value of investment securities available-for-sale as of December 31, 2004 and 2003 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
December 31, 2004				
U.S. Government agencies	\$ ,827,502	\$ -	\$ (58,058)	\$4,769,444
Mortgage-backed securities	452,594	10,084	-	462,678
Other investments	<u>195,542</u>	<u>-</u>	<u>(60)</u>	<u>195,482</u>
Total	<u>\$5,475,638</u>	<u>\$ 10,084</u>	<u>\$ (58,118)</u>	<u>\$5,427,604</u>
December 31, 2003				
U.S. Government agencies	\$7,291,595	\$ 6,803	\$ (72,022)	\$7,226,376
Mortgage-backed securities	1,332,867	14,560	-	1,347,427
Other investments	<u>50,126</u>	<u>-</u>	<u>(126)</u>	<u>50,000</u>
Total	<u>\$8,674,588</u>	<u>\$ 21,363</u>	<u>\$ (72,148)</u>	<u>\$8,623,803</u>

Investment securities with book values of \$3,484,624 and \$3,279,317 at December 31, 2004 and 2003, respectively, were pledged to secure municipal deposits and borrowings from the FHLB of Atlanta.

The amortized cost and estimated fair value of investment securities available-for-sale as of December 31, 2004, by contractual maturity, are as follows:

	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
Within one year	\$1,959,786	\$1,959,024
One to five years	513,137	505,100
More than five years	<u>3,002,715</u>	<u>2,963,480</u>
Total	<u>\$5,475,638</u>	<u>\$5,427,604</u>

During 2004 investment securities available-for-sale totaling \$9,116,000 were called or sold for gross losses of \$26,370. During 2003 investment securities available-for-sale totaling \$34,222,000 were called or sold for net losses of \$69,555. During 2002 investment securities available-for-sale totaling \$79,736,000 were called or sold for net losses of \$20,930.



### Note 3. Loans

Loans classified by type as of December 31, 2004 and 2003 are as follows:

	<u>2004</u>	<u>2003</u>
Commercial	\$ 40,491,210	\$32,821,527
Real estate - residential	15,395,373	14,278,932
Real estate - commercial	45,120,414	16,499,978
Real estate - construction	30,869,772	25,627,183
Consumer	<u>4,130,131</u>	<u>3,836,548</u>
Total loans	136,006,900	93,064,168
Less: unearned income, net	(330,578)	(403,867)
Less: Allowance for loan losses	<u>(1,514,029)</u>	<u>(1,137,794)</u>
	<u>\$134,162,293</u>	<u>\$91,522,507</u>

Gross gains on the sale of loans totaling approximately \$1,073,000, \$818,000 and \$96,000 were realized during the years ended December 31, 2004, 2003 and 2002, respectively.

Ten loans totaling \$1,134,000 at December 31, 2004 were past due 90 days or more yet interest was still being accrued.

The following is a summary of loans directly or indirectly with executive officers or directors of the Company for the year ended December 31, 2004:

Balance, January 1, 2004	\$ 8,703,061
Additions	3,059,746
Reductions	<u>7,895,868</u>
Balance, December 31, 2004	<u>\$ 3,866,939</u>

Executive officers and directors also had unused credit lines totaling \$2,314,000 at December 31, 2004. All loans and credit lines to executive officers and directors were made in the ordinary course of business at the Company's normal credit terms, including interest rate and collateralization prevailing at the time for comparable transactions with other persons.

**Note 4. Allowance for loan losses**

Activity in the allowance for loan losses in 2004, 2003 and 2002 was as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Beginning balance	\$ 1,137,794	\$ 754,866	\$ 458,092
Provision for loan losses	532,630	399,000	313,000
Acquisition of Community First	-	39,416	-
Charge-offs	(158,194)	(55,488)	(16,226)
Recoveries	<u>1,799</u>	<u>-</u>	<u>-</u>
Ending balance	<u>\$ 1,514,029</u>	<u>\$ 1,137,794</u>	<u>\$ 754,866</u>

As of December 31, 2004 and 2003, the Company had impaired loans of \$473,000 and \$336,000, respectively, which were on nonaccrual status. These impairments had valuation allowances of \$108,000 and \$158,000 as of December 31, 2004 and 2003, respectively. The Company does not record interest income on impaired loans. Interest income that would have been recorded had these loans been performing would have been \$60,000 and \$23,000 for 2004 and 2003, respectively.

**Note 5. Premises and equipment**

The following is a summary of premises and equipment as of December 31, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Land	\$2,758,965	\$ 2,761,302
Buildings and improvements	2,886,221	2,592,441
Furniture, fixtures and equipment	<u>2,092,330</u>	<u>1,908,390</u>
Total premises and equipment	7,737,516	7,262,133
Less: Accumulated depreciation and amortization	<u>(1,522,943)</u>	<u>(1,186,347)</u>
Premises and equipment, net	<u>\$6,214,573</u>	<u>\$ 6,075,786</u>

Depreciation and amortization of premises and equipment for 2004, 2003 and 2002 amounted to \$336,000, \$264,000 and \$182,000, respectively.

## Note 6. Deposits

Deposits as of December 31, 2004 and 2003 were as follows:

	<u>2004</u>	<u>2003</u>
Demand accounts	\$ 10,030,927	\$ 7,522,220
Interest checking accounts	6,453,323	4,686,374
Money market accounts	24,000,555	20,570,001
Savings accounts	4,437,962	3,279,538
Time deposits of \$100,000 and over	31,974,101	19,275,603
Other time deposits	<u>63,130,518</u>	<u>40,988,871</u>
 Total	 <u>\$140,027,386</u>	 <u>\$ 96,322,607</u>

The following are the scheduled maturities of time deposits as of December 31, 2004:

<u>Year Ending December 31,</u>	<u>Less Than \$100,000</u>	<u>Greater than or Equal to \$100,000</u>	<u>Total</u>
2005	\$32,504,483	\$19,299,504	\$51,803,987
2006	11,280,357	6,553,794	17,834,152
2007	7,039,563	1,956,531	8,996,093
2008	3,717,733	1,993,831	5,711,564
2009	<u>8,588,382</u>	<u>2,170,441</u>	<u>10,758,823</u>
	<u>\$63,130,518</u>	<u>\$31,974,101</u>	<u>\$95,104,618</u>

Deposits held at the Company by related parties, which include officers, directors, greater than 5% shareholders and companies in which directors of the Board have a significant ownership interest, approximated \$1,290,000 and \$1,872,000 at December 31, 2004 and 2003, respectively.

## Note 7. Borrowings

The Company uses both short-term and long-term borrowings to supplement deposits when they are available at a lower overall cost to the Company or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank of Atlanta, the Bank is required to own capital stock in the FHLB and is authorized to apply for advances from the FHLB. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses to which the advances may be put, as well as on the size of the advances and repayment provisions. The FHLB borrowings are secured by the pledge of U.S. Government agency securities, FHLB stock and qualified single family first mortgage loans. The FHLB advances held at December 31, 2004 mature \$2,000,000 on May 24, 2007 and \$2,000,000 on March 11, 2008.

The Company uses federal funds purchased for short-term borrowing needs. Federal funds purchased represent unsecured borrowings from other banks and generally mature daily.

Information related to borrowings is as follows:

	Year Ended December 31,	
	2004	2003
Maximum outstanding during the year		
FHLB advances	\$ 4,000,000	\$ 4,000,000
Federal funds purchased	2,957,000	2,672,000
Balance outstanding at end of year		
FHLB advances	4,000,000	4,000,000
Federal funds purchased	-	-
Average amount outstanding during the year		
FHLB advances	4,000,000	3,621,918
Federal funds purchased	171,951	121,723
Average interest rate during the year		
FHLB advances	4.40%	4.57%
Federal funds purchased	1.93%	1.64%
Average interest rate at end of year		
FHLB advances	4.36%	4.36%
Federal funds purchased	-	-

## Note 8. Income taxes

The following summarizes the tax effects of temporary differences which compose net deferred tax assets and liabilities at December 31, 2004 and 2003:

	2004	2003
Deferred tax assets		
Net operating loss carryforward	\$ -	\$ 312,479
Organizational and start-up costs	-	24,750
Allowance for loan losses	425,588	244,493
Unrealized loss on available-for-sale securities	16,381	17,267
Goodwill	10,184	-
Less valuation allowance	-	(524,986)
Total deferred tax assets	<u>452,153</u>	<u>74,003</u>
Deferred tax liabilities		
Depreciation	68,981	73,698
Other, net	5,548	305
Total deferred tax liabilities	<u>74,529</u>	<u>74,003</u>
Net deferred tax asset	<u>\$ 377,624</u>	<u>\$ -</u>

The income tax expense (benefit) charged to operations for the year ended December 31, 2004 consists of the following:

	<u>2004</u>
Current tax expense	\$ 21,934
Deferred tax benefit	<u>(361,243)</u>
Provision (benefit) for income taxes	<u>\$ (339,309)</u>

There was no provision for income taxes for the years ended December 31, 2003 and 2002.

A reconciliation of income taxes computed at the federal statutory income tax rate to total income taxes is as follows for the years ended December 31, 2004, 2003 and 2002:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net income (loss) before income taxes	<u>\$ 522,234</u>	<u>\$ 68,825</u>	<u>\$ (330,326)</u>
Computed "expected" tax expense	\$ 177,560	\$ 23,401	\$ (112,311)
Nondeductible expenses	7,200	2,777	801
Alternative minimum tax	21,934	-	-
Net operating loss carryforward	(184,760)	(23,910)	-
Valuation reserve	<u>(361,243)</u>	<u>-</u>	<u>111,510</u>
Provision (benefit) for income taxes	<u>\$ (339,309)</u>	<u>\$ -</u>	<u>\$ -</u>

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Company recorded a franchise tax expense of \$116,000, \$82,000 and \$84,000 for 2004, 2003 and 2002, respectively.

## **Note 9. Lease commitments**

The Company leases office space under two non-cancelable operating leases. These leases expire on June 30, 2006 and March 31, 2008, respectively. At December 31, 2004, the minimum total rental commitment under such non-cancelable operating leases was as follows:

2005	\$ 54,400
2006	46,500
2007	38,500
2008	<u>9,700</u>
	<u>\$149,100</u>

Total rent expense charged to operations was \$196,000, \$153,000 and \$153,000 in 2004, 2003 and 2002, respectively.

## Note 10. Commitments and contingencies

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the financial statements. The contract amounts of these instruments reflect the extent of involvement that the Company has in particular classes of instruments.

The Company's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit, and to potential credit loss associated with letters of credit issued, is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for loans and other such on-balance sheet instruments.

At December 31, 2004, the Company had outstanding the following approximate off-balance-sheet financial instruments whose contract amounts represent credit risk:

	<u>Contract Amount</u>
Undisbursed credit lines	\$ 29,355,000
Commitments to extend or originate credit	3,151,000
Standby letter of credit	<u>3,527,000</u>
Total commitments to extend credit	<u>\$ 36,033,000</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. Historically, many commitments expire without being drawn upon; therefore, the total commitment amounts shown in the above table are not necessarily indicative of future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, as deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include personal or income-producing commercial real estate, accounts receivable, inventory and equipment.

*Concentrations of credit risk* – All of the Company's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Company's market area. Although the Company is building a diversified loan portfolio, a substantial portion of its clients' ability to honor contracts is reliant upon the economic stability of the Richmond, Virginia area, including the real estate markets in the area. The concentrations of credit by type of loan are set forth in Note 3. The distribution of commitments to extend credit approximates the distribution of loans outstanding.

## **Note 11. Stockholders' equity and regulatory matters**

In September and October 2002, the Company completed an offering of its common stock through the sale of 817,200 shares at a price of \$8.50 per share. Proceeds to the Company from the offering (net of offering expenses of \$624,000) were \$6,322,000. Attached to each share was a warrant to purchase one share of common stock, at a price of \$10.20 per share, at any time through September 27, 2007, unless the warrants are cancelled. The warrants may be cancelled after December 31, 2003 by the Company in whole or in part upon 30 days' written notice if for 20 or more trading days within any period of 30 consecutive trading days, including the last day of the period, the bid price of the stock exceeds \$12.75 per share. The Company also issued 40,860 warrants to the underwriter of the offering. As of December 31, 2004, warrants to purchase 49,550 shares of the Company's common stock have been exercised and warrants to purchase 808,510 common shares remain outstanding.

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

Quantitative measures are established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 Capital to average assets (the Leverage ratio). Management believes that as of December 31, 2004, the Bank meets all capital adequacy requirements to which it is subject.

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, under capitalized, significantly under capitalized, and critically under capitalized. The Bank meets the criteria to be categorized as a "well capitalized" institution as of December 31, 2004. The "well capitalized" classification permits financial institutions to minimize the cost of FDIC insurance assessments by being charged a lesser rate than those that do not meet this definition.

The Bank's capital amounts and ratios at December 31, 2004 and 2003 are presented in the table below:

	Actual		For Capital Adequacy Purposes		To be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>December 31, 2004</b>						
Total capital (to risk-weighted assets)	\$15,842,000	10.4%	\$ 12,242,000	8.0%	\$15,302,000	10.0%
Tier 1 capital (to risk-weighted assets)	14,328,000	9.4%	6,121,000	4.0%	9,181,000	6.0%
Leverage ratio (Tier 1 capital to average assets)	14,328,000	9.4%	6,085,000	4.0%	5,593,000	5.0%
<b>December 31, 2003</b>						
Total capital (to risk-weighted assets)	\$13,845,000	13.9%	\$ 7,971,000	8.0%	\$ 9,964,000	10.0%
Tier 1 capital (to risk-weighted assets)	12,707,000	12.8%	3,986,000	4.0%	5,979,000	6.0%
Leverage ratio (Tier 1 capital to average assets)	12,707,000	11.4%	4,474,000	4.0%	5,593,000	5.0%

In addition, banking regulations limit the amount of cash dividends that may be paid without prior approval of the Bank's regulatory agencies. Such dividends are limited to the lesser of the Bank's retained earnings or the net income of the previous two years combined with the current year net income.

## **Note 12. Stock incentive and stock warrant plans**

On March 21, 2000 the Company approved the following stock incentive and warrant plans:

The Organizational Investors Warrant Plan made available 140,000 warrants for grant to the Company's initial (organizational) investors for certain risks associated with the establishment of the Company. The warrants have an exercise price of \$10 per share (which approximated the fair value per share of common stock at issuance date) and expire in April 2008. At December 31, 2004, 137,500 warrants had been issued and none had been exercised.



The Stockholder Loan Referral Warrant Plan provides for the issuance of warrants to purchase up to 50,000 shares of common stock of the Company to shareholders who refer qualifying loans that are accepted by the Company. All shareholders of record of 100 shares or more of common stock are eligible to participate in the plan. The plan applies to all qualifying loans originated during the period from May 1, 2000 through April 30, 2003. The exercise price of each warrant is equal to the fair value of a share of common stock at the date of grant and the warrant has a twelve-month term. During the year ended December 31, 2003, 9,500 warrants were issued under the plan with a weighted-average exercise price of \$7.94. Warrants to purchase 5,900 shares were exercised during 2003. Total warrants issued under this plan amounted to 36,000 and none remain outstanding at December 31, 2004. The value of the warrants issued is considered immaterial to the financial statements.

The Stock Incentive Plan initially authorizes the issuance of up to 255,000 shares of Common Stock to assist the Bank in recruiting and retaining key personnel. The following table summarizes options outstanding:

	<u>Options</u>	<u>Weighted Average Exercise Price</u>
Options outstanding January 1, 2002	136,770	\$ 8.50
Granted	16,130	8.66
Forfeited	(3,660)	8.50
Exercised	<u>-</u>	<u>-</u>
Options outstanding December 31, 2002	149,240	8.56
Granted	34,000	8.39
Forfeited	(22,340)	8.48
Exercised	<u>-</u>	<u>-</u>
Options outstanding December 31, 2003	160,900	8.44
Granted	37,850	12.16
Forfeited	(1,340)	9.86
Exercised	<u>-</u>	<u>-</u>
Options outstanding December 31, 2004	<u>197,410</u>	<u>\$ 9.14</u>
Options exercisable December 31, 2004	<u>122,610</u>	

The fair value per share of the options granted was \$4.73, \$2.69, and \$4.43 for the years ended December 31, 2004, 2003 and 2002, respectively.

The following table summarizes information about stock options outstanding at December 31, 2004:

Range of Exercise Prices	Number of Options	Outstanding		Exercisable	
		Weighted Average Remaining Years of Contractual Life	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
\$7.68 - \$9.24	160,060	7.2	\$ 8.44	122,610	\$ 8.44
\$11.20 - \$12.50	37,350	9.4	12.17	-	-
	<u>197,410</u>			<u>122,610</u>	

### Note 13. Fair values of financial instruments

The estimated fair values of the Company's financial instruments at December 31, 2004 and 2003 are as follows:

	2004		2003	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial assets</b>				
Cash and cash equivalents	\$ 8,599,407	\$ 8,599,407	\$ 5,564,441	\$ 5,564,441
Investment securities available for sale	5,427,604	5,427,604	8,623,803	8,623,803
Loans held for sale	2,867,084	2,867,084	1,502,997	1,502,997
Loans	134,162,293	134,040,889	91,522,507	91,911,200
Accrued interest receivable	610,866	610,866	391,658	391,658
<b>Financial liabilities</b>				
Deposits	140,027,38	139,946,050	96,322,607	96,533,100
FHLB borrowings	4,000,000	4,017,460	4,000,000	4,067,200
Other borrowings	835,079	835,079	804,197	804,197
Accrued interest payable	175,154	175,154	114,177	114,177
<b>Off-balance-sheet instruments</b>				
Undisbursed credit lines		29,355,000		27,955,000
Commitments to extend or originate credit		3,151,000		7,040,000
Standby letters of credit		3,527,000		525,000

**Note 14. Parent corporation only financial statements**

**Southern Community Financial Corp.  
(Parent Corporation Only)  
Balance Sheet  
December 31, 2004**

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**Assets**

Cash and due from banks	\$ 361,095
Investment in subsidiaries	14,531,524
Receivable from subsidiary	77,274
Prepaid expenses	15,266
	<hr/>
	\$ 14,985,159
	<hr/>

**Liabilities and Stockholders' Equity**

<b>Liabilities</b>	\$ -
<b>Stockholders' equity</b>	
Preferred stock	-
Common stock	7,046,976
Additional paid-in capital	8,615,748
Accumulated other comprehensive income (loss)	(31,798)
Retained earnings (deficit)	(645,767)
	<hr/>
Total stockholders' equity	14,985,159
	<hr/>
	\$ 14,985,159
	<hr/>

**Southern Community Financial Corp.  
(Parent Corporation Only)  
Statement of Operations  
Year Ended December 31, 2004**

**Expenses**

Advertising and marketing	\$ 196
Supplies	22,200
Legal	24,388
Other outside services	4,992
	<hr/>
Total expenses	51,776
	<hr/>
Net loss before undistributed equity in subsidiary	(51,776)
	<hr/>
Undistributed equity in subsidiary	913,319
	<hr/>
<b>Net income</b>	\$ 861,543
	<hr/>

**Southern Community Financial Corp.**  
**(Parent Corporation Only)**  
**Statement of Cash Flows**  
**Year Ended December 31, 2004**

**Cash Flows from Operating Activities**

Net income	\$ 861,543
Adjustments to reconcile net income to net cash provided by operating activities	
Undistributed earnings of subsidiary	(913,319)
Increase in other assets	(92,539)
	<u>(144,315)</u>
Net cash provided by operations	<u>(144,315)</u>

**Cash Flows from Financing Activities**

Proceeds from exercise of warrants	505,410
	<u>505,410</u>
Net increase in cash	361,095
Cash, beginning of year	<u>-</u>
Cash, end of year	<u>\$ 361,095</u>

**Note 15. Selected quarterly financial data (unaudited)**

Condensed quarterly financial data is shown as follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>2004</b>				
Interest income	\$ 1,669,882	\$ 1,869,791	\$ 1,904,670	\$ 2,205,224
Interest expense	600,508	675,019	684,455	808,859
Net interest income before provision for loan losses	1,069,374	1,194,772	1,220,215	1,396,365
Provision for loan losses	104,000	56,900	206,484	165,246
Gain on sale of loans	205,154	321,157	294,922	251,475
Loss on securities	(16,396)	(9,974)	-	-
Fees and other noninterest income	132,087	161,408	210,577	208,998
Noninterest expenses	1,284,262	1,351,291	1,380,200	1,569,517
Income tax benefit	-	-	-	(339,309)
Net income	1,957	259,172	139,030	461,384
Earnings per share				
Basic	\$ -	\$ 0.15	\$ 0.08	\$ 0.26
Diluted	\$ -	\$ 0.14	\$ 0.07	\$ 0.24
<b>2003</b>				
Interest income	\$ 1,057,100	\$ 1,158,635	\$ 1,385,802	\$ 1,525,588
Interest expense	432,560	457,637	540,877	572,123
Net interest income before provision for loan losses	624,540	700,998	844,925	953,465
Provision for loan losses	111,000	136,000	100,000	52,000
Gain on sale of loans	11,651	30,776	515,683	260,280
Loss on securities	(1,222)	(10,037)	(43,783)	(14,513)
Fees and other noninterest income	84,867	124,857	280,213	195,301
Noninterest expenses	698,447	759,874	1,356,857	1,274,998
Net income (loss)	(89,611)	(49,280)	140,181	67,535
Earnings (loss) per share				
Basic	\$ (0.05)	\$ (0.03)	\$ 0.08	\$ 0.04
Diluted	\$ (0.05)	\$ (0.03)	\$ 0.08	\$ 0.04

## Exhibit Index

<u>Number</u>	<u>Description</u>
3.1	Articles of Incorporation of Southern Community Financial Corp., incorporated by reference to Exhibit 3.1 of the Current Report on Form 8-K dated April 30, 2004.
3.2	Bylaws of Southern Community Financial Corp., incorporated by reference to Exhibit 3.2 of the Current Report on Form 8-K dated April 30, 2004.
10.1	Incentive Plan.
10.2	Organizational Investors Warrant Plan.
10.3	Shareholder Loan Referral Warrant Plan.
10.4	Executive Employment Agreement, effective as of April 1, 2001, between Thomas W. Winfree and Southern Community Bank & Trust.
10.5	Form of Incentive Stock Option Agreement.
10.6	Form of Non-Employee Director Non-Qualified Stock Option Agreement.
21	Subsidiaries of Southern Community Financial Corp.
31.1	Section 302 Certification by Chief Executive Officer.
31.2	Section 302 Certification by Chief Financial Officer.
32	Section 906 Certification.

Exhibit 10.1

### **SOUTHERN COMMUNITY FINANCIAL CORP. INCENTIVE PLAN**

#### **Article I**

#### **DEFINITIONS**

1.01 Affiliate means any “subsidiary” or “parent corporation” (within the meaning of Section 424 of the Code) of the Company.

1.02 Agreement means a written agreement (including any amendment or supplement thereto) between the Company and a Participant specifying the terms and conditions of a Grant or an Award issued to such Participant.

1.03 Award means an award of Common Stock, Restricted Stock and/or Phantom Stock.

1.04 Board means the Board of Directors of the Company.

1.05 Change of Control means and shall be deemed to have taken place if: (i) a third person, including a “group” as defined in Section 13(d)(3) of the Securities Exchange Act of 1934, who after the effective date of the Plan becomes the beneficial owner of shares of the Company having 20 percent or more of the total number of votes that may be cast for the election of Directors of the Company; or, (ii) as the result of, or in connection with, any cash tender

or exchange offer, merger or other business combination, sale of assets or contested election, or any combination of the foregoing transactions (a “Transaction”), the persons who were Directors of the Company before the Transaction shall cease to constitute a majority of the Board of the Company or any successor to the Company.

1.06 Change of Control Date is the date on which an event described in (i) or (ii) of Section 1.05 occurs.

1.07 Code means the Internal Revenue Code of 1986, and any amendments thereto.

1.08 Common Stock means the Common Stock of the Company.

1.09 Company means Southern Community Financial Corp.

1.10 Fair Market Value means, on any given date, the average of the bid and asked prices at closing of a share of Common Stock on the Market on such day or, if the Common Stock was not traded on such day, then on the next preceding day that the Common Stock was traded, all as reported by such source as the Board may select, or if the Common Stock does not trade on the Nasdaq Stock Market, the value that the Board, in its good faith business judgment, shall designate.

1.11 Grant means the grant of an Option and/or an SAR.

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1.12 Incentive Stock Option means an Option that is intended to qualify as an “incentive stock option” under Section 422 of the Code.

1.13 Initial Value means, with respect to an SAR, the Fair Market value of one share of Common Stock on the date of grant, as set forth in the Agreement.

1.14 Non-Qualified Stock Option means an option other than an Incentive Stock Option.

1.15 Option means a stock option that entitles the holder to purchase from the Company a stated number of shares of Common Stock at the price set forth in an Agreement.

1.16 Option Price means the price per share for Common Stock purchased on the exercise of an Option as provided in Article VI.

1.17 Participant means an employee of the Company or of a Subsidiary, including an employee who is a member of the Board, who satisfies the requirements of Article IV and is selected by the Board to receive a Grant or an Award.

1.18 Phantom Stock means a bookkeeping entry on behalf of a Participant by which his account is credited (but not funded) as though Common Stock had been transferred to such account.

1.19 Plan means the Southern Community Financial Corp. Incentive Plan.

1.20 Restricted Stock means shares of Common Stock awarded to a Participant under Article IX. Shares of Common Stock shall cease to be Restricted Stock when, in accordance with the terms of the applicable Agreement, they become transferable and free of substantial risks of forfeiture.

1.21 Rule 16b-3 means Rule 16b-3, as promulgated by the Securities and Exchange Commission under Section 16(b) of the Securities Exchange Act of 1934, as amended from time to time.

1.22 SAR means a stock appreciation right that entitles the holder to receive, with respect to each share of Common Stock encompassed by the exercise of such SAR, the lesser of (a) the excess of the Fair Market Value at the time of exercise over the Initial Value of the SAR or (b) the Initial Value of the SAR.

1.23 Securities Broker means the registered securities broker acceptable to the Company who agrees to effect the cashless exercise of an Option pursuant to Section 8.05 hereof.

1.24 Subsidiary means any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company if each of the corporations in the chain (other than the last corporation) owns stock possessing at least 50 percent of the total combined voting power of all classes of stock in one of the other corporations in such chain.



## **Article II**

### **PURPOSES**

The Plan is intended to assist the Company in recruiting and retaining key employees with ability and initiative by enabling employees who contribute significantly to the Company or an Affiliate to participate in its future success and to associate their interests with those of the Company and its shareholders. The Plan is intended to permit the award of Common Stock, Restricted Stock, and Phantom Stock, and the issuance of Options qualifying as Incentive Stock Options or Non-Qualified Stock Options as designated by the Board at time of grant, and SARs. No Option that is intended to be an Incentive Stock Option, however, shall be invalid for failure to qualify as an Incentive Stock Option under Section 422 of the Code but shall be treated as a Non-Qualified Stock Option.

## **Article III**

### **ADMINISTRATION**

The Plan shall be administered by the Board. The Board shall have authority to issue Grants and Awards upon such terms (not inconsistent with the provisions of this Plan) as the Board may consider appropriate. The terms of such Grants and Awards may include conditions (in addition to those contained in this Plan) on (i) the exercisability of all or any part of an Option or SAR and (ii) the transferability or forfeitability of Restricted Stock or Phantom Stock. In addition, the Board shall have complete authority to interpret all provisions of this Plan; to prescribe the form of Agreements; to adopt, amend, and rescind rules and regulations pertaining to the administration of the Plan; and to make all other determinations necessary or advisable for the administration of this Plan.

Any decision made, or action taken, by the Board or in connection with the administration of this Plan shall be final and conclusive. All expenses of administering this Plan shall be borne by the Company.

## **Article IV**

### **ELIGIBILITY**

4.01 General. Any employee of the Company or of any Subsidiary (including any corporation that becomes a Subsidiary after the adoption of this Plan) who, in the judgment of the Board, has contributed significantly or can be expected to contribute significantly to the profits or growth of the Company or a Subsidiary may receive one or more Awards or Grants, or any combination or type thereof. Directors of the Company who are employees are eligible to participate in this Plan.

4.02 Grants and Awards. The Board will designate individuals to whom Grants and/or Awards are to be issued and will specify the number of shares of Common Stock subject to each such Grant or Award. An Option may be granted with or without a related SAR. An SAR may be granted with or without a related Option. All Grants or Awards issued under this Plan shall be evidenced by Agreements which shall be subject to applicable provisions of this Plan and to

such other provisions as the Board may adopt. No Participant may be granted Options that are Incentive Stock Options, or related SARs (under all Incentive Stock Option Plans of the Company and Affiliates) which are first exercisable in any calendar year for stock having an aggregate Fair Market Value (determined as of the date an Option is granted) exceeding \$100,000.

4.03 Reload Options. The Board shall have the authority to specify at the time of Grant that an optionee shall be granted the right to a further Non-Qualified Stock Option (a "Reload option") in the event such optionee exercises all or a part of an Option, including a Reload Option (an "Original option"), by surrendering in accordance with Section 8.02 hereof already owned shares of Common Stock in full or partial payment of the Option Price under such original Option. Each Reload option shall be granted on the date of exercise of the Original option, shall cover a number of shares of Common Stock not exceeding the whole number of shares of Common Stock surrendered in payment of the Option Price under such Original Option, shall have an Option Price equal to the Fair Market Value on the date of Grant of such Reload Option, shall expire on the stated expiration date of the Original option and shall be subject to such other terms and conditions as the Board may determine.

4.04 Designation of Option as an Incentive Stock Option or a Non-Qualified Stock Option. The Board will designate at the time an Option is granted whether the Option is to be treated as an Incentive Stock Option or a Non-Qualified Stock Option. In the absence, however, of any such designation, such Option shall be treated as a Non-Qualified Stock Option.

## **Article V**

### **STOCK SUBJECT TO PLAN**

The maximum number of shares of Common Stock available for Grants and Awards under the Plan shall be 255,000, of which 14,100 shall be available only as Reload Options. Such maximum number of shares of Common Stock is subject to adjustment as provided in Article XI. Shares of Common Stock subject to Grants and Awards under the Plan may be authorized but previously unissued shares of Common Stock or previously issued shares of Common Stock reacquired by the Company. The grant of a Reload option under the Plan, by restoring an option opportunity on the number of shares of Common Stock surrendered to exercise an Original Option, will encourage a Participant to maximize his ownership interest in the Company without reducing the percentage interests of shareholders.

If any shares of Restricted Stock are forfeited for which the Participant did not receive any benefits of ownership (other than voting rights), or if any Option or any SAR terminates without being exercised, or if any SAR is exercised for cash, shares of Common Stock subject to such Grants or Awards shall be available for distribution in connection with Grants or Awards under the Plan.

## Article VI

### OPTION PRICE

The price per share for Common Stock purchased on the exercise of an Option shall be fixed by the Board on the date of grant; provided, however, that in the case of an Option that is an Incentive Stock Option, the price per share shall not be less than the Fair Market Value on such date.

## Article VII

### EXERCISE OF OPTIONS

7.01 Maximum Option or SAR Period. The period in which an option or SAR may be exercised shall be determined by the Board on the date of grant; provided, however that an Incentive Stock Option or related SAR shall not be exercisable after the expiration of 10 years from the date the Incentive Stock Option was granted.

7.02 Nontransferability. Any Option or SAR granted under this Plan shall be nontransferable except by will or by the laws of descent and distribution. In the event of any such transfer, the Option and any related SAR must be transferred to the same person or persons, trust or estate. During the lifetime of the Participant to whom an Incentive Stock Option or related SAR is granted, the Option or SAR may be exercised only by the Participant. No right or interest of a Participant in any Option or SAR shall be liable for, or subject to, any lien, obligation, or liability of such Participant.

7.03 Employee Status. For purposes of determining the applicability of Section 422 of the Code (relating to incentive stock options), or in the event that the terms of any Grant provide that it may be exercised only during employment or within a specified period of time after termination of employment, the Board may decide to what extent leaves of absence for governmental or military service, illness, temporary disability, or other reasons shall not be deemed interruptions of continuous employment.

## Article VIII

### METHOD OF EXERCISE

8.01 Exercise. Subject to the provisions of Articles VII and XII, an Option or SAR may be exercised in whole at any time or in part from time to time at such times and in compliance with such requirements as the Board shall determine; provided, however, that a SAR that is related to an Option may be exercised only to the extent that the related option is exercisable and when the Fair Market Value exceeds the Option Price of the related Option. An Option or SAR granted under this Plan may be exercised with respect to any number of whole shares less than the full number for which the option or SAR could be exercised. Such partial exercise of an Option or SAR shall not affect the right to exercise the Option or SAR from time to time in accordance with this Plan with respect to remaining shares subject to the Option or related SAR. The exercise of an Option shall result in the termination of the SAR to the extent of the number of shares with respect to which the Option is exercised.

8.02 Payment. Unless otherwise provided by the Agreement, payment of the Option Price shall be made in cash. If the Agreement provides, payment of all or part of the option Price may be made by withholding shares of Common Stock upon exercise of an Option or by surrendering already owned shares of Common Stock to the Company, provided the shares withheld or surrendered have a Fair Market Value (determined as of the day preceding the date of exercise) that is not less than such price or part thereof. In addition, the Board may establish such payment or other terms as it may deem to be appropriate and consistent with these purposes.

8.03 Determination of Payment of Cash and/or Common Stock Upon Exercise of SAR. At the Board's discretion, the amount payable as a result of the exercise of an SAR may be settled in cash, Common Stock, or a combination of cash and Common Stock. No fractional shares shall be delivered upon the exercise of an SAR but a cash payment will be made in lieu thereof.

8.04 Shareholder Rights. No participant shall have any rights as a shareholder with respect to shares subject to his Option or SAR until the date he exercises such Option or SAR.

8.05 Cashless Exercise. To the extent permitted under the applicable laws and regulations, at the request of the Participant and with the consent of the Board, the Company agrees to cooperate in a "cashless exercise" of the Option. The cashless exercise shall be effected by the Participant delivering to the Securities Broker instructions to exercise all or part of the Option, including instructions to sell a sufficient number of shares of Common Stock to cover the costs and expenses associated therewith.

## **Article IX**

### **COMMON STOCK AND RESTRICTED STOCK**

9.01 Award. In accordance with the provisions of Article IV, the Board will designate employees to whom an award of Common Stock and/or Restricted Stock is to be made and will specify the number of shares of Common Stock covered by such award or awards.

9.02 Vesting. In the case of Restricted Stock, on the date of the award, the Board may prescribe that the Participant's rights in the Restricted Stock shall be forfeitable or otherwise restricted for a period of time set forth in the Agreement and/or until certain financial performance objectives are satisfied as determined by the Board in its sole discretion. Subject to the provisions of Article XII hereof, the Board may award Common Stock to a Participant which is not forfeitable and is free of any restrictions or transferability.

9.03 Shareholder Rights. Prior to their forfeiture in accordance with the terms of the Agreement and while the shares are Restricted Stock, a Participant will have all rights of a shareholder with respect to Restricted Stock, including the right to receive dividends and vote the shares; provided, however, that (i) a Participant may not sell, transfer, pledge, exchange, hypothecate, or otherwise dispose of Restricted Stock, (ii) the Company shall retain custody of the certificates evidencing shares of Restricted Stock, and (iii) the Participant will deliver to the Company a stock power, endorsed in blank, with respect to each award of Restricted Stock.

## Article X

### PHANTOM STOCK

10.01 Award. Pursuant to this Plan or a separate plan or an agreement establishing additional terms and conditions, the Board may designate employees to whom awards of Phantom Stock may be made and will specify the number of shares of Common Stock covered by the award.

10.02 Vesting. The Board may prescribe such terms and conditions under which a Participant's right to receive payment for Phantom Stock shall become vested.

10.03 Shareholder Rights. A Participant for whom Phantom Stock has been credited generally shall have none of the rights of a shareholder with respect to such Phantom Stock. However, a plan or agreement for the use of Phantom Stock may provide for the crediting of a Participant's Phantom Stock account with cash or stock dividends declared with respect to Common Stock represented by such Phantom Stock.

10.04 Payment. Payment to a Participant for Phantom Stock credited to his account shall be made in cash, Common Stock or a combination of both unless otherwise provided in any plan or agreement.

## Article XI

### ADJUSTMENT UPON CHANGE IN COMMON STOCK

Should the Company effect one or more (x) stock dividends, stock split-ups, subdivisions or consolidations of shares or other similar changes in capitalization; (y) spin-offs, spin-outs, split-ups, split-offs, or other such distribution of assets to shareholders; or (z) direct or indirect assumptions and/or conversions of outstanding Options due to an acquisition of the Company, then the maximum number of shares as to which Grants and Awards may be issued under this Plan shall be proportionately adjusted and their terms shall be adjusted as the Board shall determine to be equitably required, provided that the number of shares subject to any Grant or Award shall always be a whole number. Any determination made under this Article XI by the Board shall be final and conclusive.

The issuance by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, for cash or property or for labor or services, either upon direct sale or upon the exercise of rights or warrants to subscribe therefor, or upon conversion of shares or obligations of the Company convertible into such shares or other securities, shall not affect, and no adjustment by reason thereof shall be made with respect to any Grant or Award.

## Article XII

### COMPLIANCE WITH LAW AND APPROVAL OF REGULATORY BODIES

No Grant shall be exercisable, no Common Stock shall be issued, no certificates for shares of Common Stock shall be delivered, and no payment shall be made under this Plan except in compliance with all applicable Federal and state laws and regulations (including, without limitation, withholding tax requirements) and the rules of all domestic stock exchanges on which the Company's shares may be listed. The Company may rely on an opinion of its counsel as to such compliance. Any share certificate issued to evidence Common Stock for which a Grant is exercised or an Award is issued may bear such legends and statements as the Board may deem advisable to assure compliance with Federal and state laws and regulations. No Grant shall be exercisable, no Common Stock shall be issued, no certificate for shares shall be delivered, and no payment shall be made under this Plan until the Company has obtained such consent or approval as the Board may deem advisable from regulatory bodies having jurisdiction over such matters.

## Article XIII

### GENERAL PROVISIONS

13.01 Effect on Employment. Neither the adoption of this Plan, its operation, nor any documents describing or referring to this Plan (or any part thereof) shall confer upon any employee any right to continue in the employ of the Company or a Subsidiary or in any way affect any right and power of the Company or a Subsidiary to terminate the employment of any employee at any time with or without assigning a reason therefor.

13.02 Unfunded Plan. The Plan, insofar as it provides for a Grant or an award of Phantom Stock, is not required to be funded, and the Company shall not be required to segregate any assets that may at any time be represented by a Grant or an award of Phantom Stock under this Plan.

13.03 Change of Control. At the discretion of the Board, a Participant's interest in Restricted Stock or phantom Stock may be made nonforfeitable and transferable as of a Change of Control Date. The Board may also provide in an Agreement that a Participant may elect, by written notice to the Company within 60 days after a Change of Control Date, to receive, in exchange for shares that were Restricted Stock or Phantom Stock immediately before the Change of Control Date, a cash payment equal to the Fair Market Value of the shares surrendered on the last business day the Common Stock is traded on the Nasdaq Stock Market prior to receipt by the Company of such written notice. Notwithstanding any other provision in this Plan to the contrary, unless the Board provides otherwise in an Agreement, a Grant may be exercised immediately in full upon a Change of Control.

13.04 Rules of Construction. Headings are given to the articles and sections of this Plan for ease of reference. The reference to any statute, regulation, or other provision of law shall be construed to refer to any amendment to or successor of such provision of law.

13.05 Amendment. The Board may amend or terminate this Plan from time to time; provided, however, that no amendment may become effective until shareholder approval is obtained if the amendment (i) materially increases the aggregate number of shares that may be issued pursuant to Options and Common Stock and Restricted Stock awards, (ii) materially increases the benefits to Participants under the Plan, or (iii)-materially changes the class of employees eligible to become Participants. No amendment shall, without a Participant's consent, adversely affect any rights of such Participant under any Grant or Award outstanding at the time such amendment is made, except such an amendment made to cause the Plan to qualify for the Rule 16b-3 exemption. No amendment shall be made if it would disqualify the Plan from the exemption provided by Rule 16b. The Board may amend the terms of any Grant or Award theretofore issued under this Plan, prospectively or retrospectively, and include in such amendment the right of the Board to pay a Participant cash in lieu of shares of Common Stock upon the termination (by exercise or otherwise) of an Option, but no such amendment shall impair the rights of any Participant without the Participant's consent except such an amendment made to cause the Plan, or Grant or Award, to qualify for the exemption provided by Rule 16b.

13.06 Duration of Plan. No Grant or Award may be issued under this Plan before April 1, 2000, or after March 31, 2010; provided, however, a Grant of a Reload Option may be issued after June 30, 2001, upon the exercise of an Original option as provided in Section 4.03 hereof.

13.07 Shareholder Approval. This Plan has been approved by the Board of Directors of the Company and shall be effective as of March 1, 2000 subject, however, to approval by the shareholders of the Company entitled to vote at the 2000 Annual Meeting of Shareholders.

## **SOUTHERN COMMUNITY BANK & TRUST ORGANIZATIONAL INVESTORS WARRANT PLAN**

### **Article I**

#### **PURPOSE**

The Organizational Investors Warrant Plan (the "Plan") is intended to reward and foster the long-term relationship and loyalty of the forty-seven individuals who, through their initial aggregate purchase of 140,000 shares of common stock (the "Organizational Investors"), facilitated the organization of Southern Community Bank & Trust (the "Bank").

### **Article II**

#### **GENERAL PROVISIONS**

2.01 General. The Plan authorizes the Board of Directors of the Bank (the "Board") to issue warrants that grant each of the Organizational Investors the right to purchase common stock of the Bank in an amount equal to the number of shares originally purchased by that individual for a purchase price of \$10.00 per share.

2.02 Grants. The Board shall designate individuals to whom warrants are to be granted and will specify the number of shares of common stock of the Bank subject to each warrant. All warrants granted under the Plan shall be evidenced by Agreements which shall be subject to applicable provisions of the Plan and to such other provisions as the Board may adopt.

2.03 Shares Subject to the Plan. Upon the exercise of any warrant, the Bank shall deliver to the individual to whom the warrant is granted authorized but unissued shares of common stock of the Bank. The maximum aggregate number of shares of common stock of the Bank that may be issued pursuant to the exercise of warrants under the Plan is 140,000, subject to the adjustments set forth in Article V.

### **Article III**

## **ADMINISTRATION**

The Board shall administer the Plan and shall have the authority to grant warrants upon such terms, not inconsistent with the provisions of the Plan, as the Board may consider appropriate. Such terms may include without limitation conditions on the exercisability of all or any part of the warrants. In addition, the Board shall have complete authority to interpret all provisions of the Plan; to adopt, amend and rescind rules and regulations pertaining to the administration of the Plan; and to make all other determinations necessary or advisable for the administration of the Plan. Any decision made, or action taken, by the Board in connection with the administration of the Plan shall be final and conclusive. No member of the Board shall be liable for any act done with respect to the Plan. All expenses of administering the Plan shall be borne by the Bank.

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## **Article IV**

### **EXERCISE OF WARRANTS**

4.01. Expiration. No warrant issued pursuant to the Plan shall be exercised after April 30, 2008.

4.02 Nontransferability. Any warrant issued under the Plan shall be nontransferable except by will or by the laws of descent and distribution. During the lifetime of each of the Organizational Investors to whom the warrant is granted, the warrant may be exercised only by that individual. No right or interest of that individual in the warrants shall be subject to, any lien, obligation, or liability of such individual.

## **Article V**

### **ADJUSTMENTS**

Should the Bank effect one or more stock dividends, stock splits, subdivisions or consolidations of shares, the number of shares as to which warrants may be granted under the Plan shall be proportionately adjusted and the terms of the warrants shall be adjusted as the Board shall determine to be equitably required. Any determination made under this Article V by the Board shall be final and conclusive.

The issuance by the Bank of shares of stock of any class, or securities convertible into shares of stock of any class, for cash or property or for labor or services, either upon direct sale or upon the exercise of rights, options or warrants to subscribe therefor, or upon conversion of shares or obligations of the Bank convertible into such shares or other securities, shall not affect, and no adjustment by reason thereof shall be made with respect to, the warrants.

## **Article VI**

### **AMENDMENT**

The Board may amend the Plan from time to time; provided, however, that no amendment may become effective until shareholder approval of such amendment is obtained if the amendment increases the aggregate number of shares that may be issued pursuant to warrants, except as set forth in Article V.

## **SOUTHERN COMMUNITY BANK & TRUST STOCKHOLDER LOAN REFERRAL WARRANT PLAN**

### **Article I**

#### **PURPOSE**

The Stockholder Loan Referral Warrant Plan (the "Plan") is intended to further develop the loan portfolio of Southern Community Bank & Trust (the "Bank") by rewarding shareholders of the Bank for significant loan referrals thereto.

### **Article II**

#### **GENERAL PROVISIONS**

2.01 General. The Plan authorizes the Board of Directors of the Bank (the "Board") to issue warrants that grant each eligible shareholder of the Bank the right to purchase common stock of the Bank for a purchase price equal to the fair market value per share at the time of issuance; provided, however, no warrant shall be granted at a price which is less than 100 percent of the book value per share of the common stock of the Bank as shown by the Bank's last published statement prior to the granting of

the warrant.

2.02 Term and Eligibility. The Plan shall apply to all loan referrals to which completed written loan applications are submitted to the Bank on or after May 1, 2000, but prior to the close of business on April 30, 2001. All shareholders of the Bank that are the record owners of 100 or more shares of common stock of the Bank, and that are not members of the Board or employees of the Bank, are eligible shareholders pursuant to the Plan ("Eligible Shareholders").

2.03 Issuance. The Executive Committee of the Board, in its sole discretion, shall designate individuals to whom warrants are to be granted and will specify the number of shares of common stock of the Bank subject to each warrant; provided, however, that no warrant shall be issued under the Plan to an Eligible Shareholder unless the loan referred (i) is for a principal amount of \$50,000 or more, and (ii) is accepted and entered into by the Bank. All warrants granted under the Plan shall be evidenced by Agreements which shall be subject to applicable provisions of the Plan and to such other provisions as the Board may adopt.

2.04 Shares Subject to the Plan. Upon the exercise of any warrant, the Bank shall deliver to the individual to whom the warrant is granted authorized but unissued shares of common stock of the Bank. The maximum aggregate number of shares of common stock of the Bank that may be issued pursuant to the exercise of warrants under the Plan is 50,000, subject to the adjustments set forth in Article V.

### **Article III**

#### **ADMINISTRATION**

The Board shall administer the Plan and shall have the authority to grant warrants upon such terms, not inconsistent with the provisions of the Plan, as the Board may consider appropriate. Such

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terms may include without limitation conditions on the exercisability of all or any part of the warrants. In addition, the Board shall have complete authority to interpret all provisions of the Plan; to adopt, amend and rescind rules and regulations pertaining to the administration of the Plan; and to make all other determinations necessary or advisable for the administration of the Plan. Any decision made, or action taken, by the Board in connection with the administration of the Plan shall be final and conclusive. No member of the Board shall be liable for any act done with respect to the Plan. All expenses of administering the Plan shall be borne by the Bank.

#### **Article IV**

### **EXERCISE OF WARRANTS**

4.01 Exercise. Subject to the provisions of this Article IV, the warrants issued under the Plan may be exercised in whole at any time. No warrant may be exercised for a number of shares less than the full number of shares for which the warrant could be exercised.

4.02 Expiration. No warrant issued pursuant to the Plan shall be exercisable after twelve months from the date of issuance.

4.03 Nontransferability. Any warrant issued under the Plan shall be nontransferable except by will or by the laws of descent and distribution. During the lifetime of each of the Organizational Investors to whom the warrant is granted, the warrant may be exercised only by that individual. No right or interest of that individual in the warrants shall be subject to, any lien, obligation, or liability of such individual.

#### **Article V**

### **ADJUSTMENTS**

Should the Bank effect one or more stock dividends, stock splits, subdivisions or consolidations of shares, the number of shares as to which warrants may be granted under the Plan may be proportionately adjusted and the terms of the warrants may be adjusted as the Board shall determine to be equitably required. Any determination made under this Article V by the Board shall be final and conclusive.

The issuance by the Bank of shares of stock of any class, or securities convertible into shares of stock of any class, for cash or property or for labor or services, either upon direct sale or upon the exercise of rights, options or warrants to subscribe therefore, or upon conversion of shares or obligations of the Bank convertible into such shares or other securities, shall not affect, and no adjustment by reason thereof shall be made with respect to, the warrants.

#### **Article VI**

### **AMENDMENT**

The Board may amend the Plan from time to time; provided, however, that no amendment may become effective until shareholder approval of such amendment is obtained if the amendment increases the aggregate number of shares that may be issued pursuant to warrants, except as set forth in Article V.

### **EMPLOYMENT AGREEMENT**

**THIS AGREEMENT**, entered into as of the \_\_\_ day of March, 2001, by and between **SOUTHERN COMMUNITY BANK & TRUST**, a Virginia chartered bank corporation (the "Corporation") **THOMAS W.**

**WINFREE** (the "Executive") is made effective on April 1, 2001. At the discretion of the Executive, he can accelerate the effective date of this Agreement to a date before April 1, 2001, and

**WITNESSETH:**

**WHEREAS**, the Corporation desires to retain the services of Executive on the terms and conditions set forth herein and, for purpose of effecting the same, the Board of Directors of the Corporation has approved this Employment Agreement and authorized its execution and delivery on the Corporation's behalf to the Executive; and

**WHEREAS**, the Executive has significant experience serving in senior bank management positions, including those of President and Chief Executive Officer, and the Corporation desires to employ the Executive as a key executive officer of the Corporation whose dedication, availability, advice and counsel to the corporation is deemed important to the Board of Directors of the Corporation, the Corporation and its stockholders;

**WHEREAS**, the services of the Executive, his experience and knowledge of the affairs of the Corporation, and his reputation and contacts in the industry are valuable to the Corporation; and

**WHEREAS**, the Corporation wishes to attract and retain such well qualified executives and it is in the best interests of the Corporation and of the Executive to secure the services of the Executive; and

**WHEREAS**, the Corporation considers the establishment and maintenance of a sound management to be part of its overall corporate strategy and to be essential to protecting and enhancing the best interests of the Corporation and its stockholders; and

**NOW, THEREFORE**, to assure the Corporation of the Executive's dedication, the availability of his advice and counsel to the Board of Directors of the Corporation, and to induce the Executive to remain and continue in the employ of the Corporation and for other good and valuable consideration, the receipt and adequacy whereof each party hereby acknowledges, the Corporation and the Executive hereby agree as follows:

**1. EMPLOYMENT**: The Corporation agrees to, and does hereby, employ Executive, and the Executive agrees to, and does hereby, accept such employment, for the period beginning on or before April 1, 2001 and ending on March 31, 2004, which period of employment may be extended or terminated only upon the terms and conditions hereinafter set forth.

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**2. ANNUAL REVIEWS-EXTENSIONS OF TERM :** The Corporation's fiscal year begins on January 1 and ends on December 31. Within thirty days after the end of each fiscal year, beginning with the year that ends December 31, 2001, the Board of Directors of the Corporation shall review the Executive's performance for the immediately preceding fiscal year. After each such review, this Agreement may be extended for successive terms of twelve (12) months each by an appropriate written instrument executed by the Executive and on behalf of the Corporation. Any decision by the Corporation to extend this Agreement shall not bind the Corporation unless such decision is reviewed and approved by the Board of Directors of the Corporation. If this Agreement is not extended in writing before the end of its term (as such term may have been extended) or expressly terminated, it shall automatically terminate at the end of its term (as such term may have been extended).

**3. EXECUTIVE DUTIES :** Executive agrees that, during the term of his employment under this Agreement and in his capacity Chief Executive Officer, he will devote his full business time and energy to the business, affairs and interests of the Corporation and serve it diligently and to the best of his ability.\* The services and duties to be performed by Executive shall be those appropriate to his office and title as currently and from time to time hereafter specified in the Corporation's By-laws or otherwise specified by its Board of Directors. As Chief Executive Officer, the Executive will be the senior officer of the Corporation responsible for all day-to-day operations of the Corporation, have ultimate decision making authority for the Corporation in day-to-day operations, and to whom the President of the Corporation will directly report. The Executive may also be appointed President of the Corporation by the Board of Directors. The Executive shall be a member of and report to the Board of Directors, and shall be a member of the Executive Committee.

**4. COMPENSATION :** The Corporation agrees to pay Executive, and Executive agrees to accept, as compensation for all services rendered by him to the Corporation during the period of his employment under this Agreement, base salary at the annual rate of One Hundred Twenty Thousand Dollars (\$120,000.00), which shall be payable in monthly, semi-monthly or bi-weekly installments in conformity with Corporation's policy relating to salaried employees. Such salary may be increased in the sole and absolute discretion of the Corporation's Board of Directors or Committee thereof duly authorized by the Board to so act. The Board of Directors, in its discretion, may cause the Corporation to pay bonuses to the Executive from time to time.

**5. PARTICIPATION IN BENEFIT PLANS, REIMBURSEMENT OF BUSINESS EXPENSES AND OTHER BENEFITS :** (i) During the term of employment under this Agreement, Executive shall be entitled to participate in any pension, group insurance, hospitalization, deferred compensation or other benefit, bonus or incentive plans of the Corporation presently in effect (including, without limitation, stock option plans) or hereafter adopted by the Corporation and generally available to any employees of senior executive status, and, additionally, Executive shall be entitled to have the use of Corporation's facilities and executive benefits as are customarily made available by the Corporation to its executive officers.

\* Notwithstanding the foregoing, the Corporation acknowledges that Executive is the managing member of a Virginia limited liability company (The Warrenton Office Building, L.L.C.) that owns and operates an office building in Warrenton, Virginia. The Corporation agrees that so long as it does not interfere with his duties hereunder, Executive may continue to act as the managing member of The Warrenton Office Building, L.L.C.

(ii) During the term of this Agreement, to the extent that such expenditures are substantiated by the Executive as required by the Internal Revenue Service and policies of the Corporation, the Corporation shall reimburse the Executive promptly for all expenditures (including travel, entertainment, parking, business meetings, and the monthly costs, including dues, of maintaining memberships at appropriate clubs) made in accordance with rules and policies established from time to time by the Board of Directors of the Corporation in pursuance and furtherance of the Corporation's business and good will.

(iii) The Corporation shall provide either an automobile for the Executive's personal and business use (for which Executive will pay \$100.00 per month) or provide a monthly stipend of Five Hundred Dollars (\$500.00) to the Executive for the maintenance of the Executive's automobile. The option selected will be decided with the assistance of the Corporation's public accounting firm auditors.

**6. ILLNESS :** In the event Executive is unable to perform his duties with reasonable accommodations under this Agreement on a full-time basis for a period of four (4) consecutive months by reason of illness or other physical or mental disability, and at or before the end of such period he does not return to work on a full-time basis, the Corporation may terminate this Agreement without further or additional compensation payment being due the Executive from the Corporation pursuant to this Agreement, except benefits accrued through the date of such termination under employee benefit plans of the Corporation. These benefits shall include long-term disability and other insurance or other benefits then regularly provided by the Corporation to disabled employees, as well as any other insurance benefits so provided.

**7. DEATH :** In the event of Executive's death during the term of this Agreement, this Agreement shall terminate as of the end of the month in which Executive dies. This Section 7 shall not affect the rights of any person under other contract between the Executive and either the Corporation or under any life insurance policy.

**8. TERMINATION WITHOUT CAUSE/RESIGNATION FOR GOOD REASON :**

(a) Notwithstanding the provisions of Section 1 hereof, the Board of Directors of the Corporation may, without Cause (as hereafter defined), terminate the Executive's employment under this Agreement at any time in any lawful manner by giving not less than thirty (30) days written notice to the Executive. The Executive may resign for Good Reason (as hereafter defined) at any time by giving not less than thirty (30) days written notice to the Corporation. If the Corporation terminates the Executive's employment without Cause or the Executive resigns for Good Reason, then in either event:

(i) The Executive shall be paid for the remainder of the then current term of this Agreement, at such times as payment was theretofore made, the salary required under Section 4 that the Executive would have been entitled to receive during the remainder of the then current term of this Agreement had such termination not occurred; and

(ii) The Corporation shall maintain in full force and effect for the continued benefit of the Executive for the next six (6) months following the month in which the termination

occurs, all employee benefit plans and programs or arrangements in which the Executive was entitled to participate immediately prior to such termination, provided that continued participation is possible under the general terms and provisions of such plans and programs. In the event that Executive's participation in any such plan or program is barred, the Corporation shall arrange to provide the Executive with benefits substantially similar to those which the Executive was entitled to receive under such plans and program.

(iii) The Executive shall thereon have no further recourse, and the Corporation shall have no further obligation, under the Agreement.

(b) For purposes of this Agreement, "Good Reason" shall mean:

(i) The assignment of duties to the Executive by the Corporation which (A) are materially different from the Executive's duties on the date hereof or (B) result in the Executive having significantly less authority and/or responsibility than he has on the date hereof, without his express written consent;

(ii) The removal of the Executive from or any failure to re-elect him to the position of President and Chief Executive Officer of the Corporation, except in connection with a termination of his employment by the Corporation for Cause or by reason of the Executive's disability;

(iii) A reduction by the Corporation of the Executive's base salary to less than One Hundred Twenty Thousand Dollars (\$120,000.00) per year,

(iv) The failure of the Corporation to provide the Executive with substantially the same fringe benefits (including paid vacations) provided for in this Agreement; or

(v) The failure of the Corporation to obtain the assumption of and agreement to perform this Agreement by any successor as contemplated in Section 11(c) hereof.

(c) Resignation by the Executive for Good Reason shall be communicated by a written Notice of Resignation to the Corporation. A "Notice of Resignation" shall mean a notice which shall indicate the specific provision(s) in this Agreement relied upon and shall set forth in reasonable detail the facts and circumstances claimed to provide a basis for a resignation for Good Reason.

(d) If within thirty (30) days after any Notice of Resignation is given the Corporation notifies the Executive that a dispute exists concerning the resignation for Good Reason and that it is requesting arbitration pursuant to Section 18, the Corporation shall continue to pay the Executive his full salary and benefits as described in Sections 4 and 5, as and when due and payable, at least until such time as a final decision is reached by the panel of arbitrators. If Good Reason for resignation by the Executive is ultimately determined not to exist, then all sums paid by the Corporation to the Executive, including but not limited to the cost to the Corporation of providing the Executive such fringe benefits, from the date of such resignation to the date of the resolution of such dispute shall be promptly repaid by the Executive to the Corporation with interest at the rate charged from time to time by the Corporation to its most substantial customers for unsecured extensions of credit. Should it ultimately be determined that Good Reason for

resignation by the Executive is ultimately determined to exist, then the Executive shall be entitled to retain all sums paid to him pending the resolution of such dispute and he shall be entitled to receive, in addition, the payments and other benefits provided for in Section 8(a).

A failure by the Corporation to notify the Executive that a dispute exists concerning the resignation for Good Reason within thirty (30) days after any Notice of Resignation is given shall constitute a final waiver by the Corporation of its right to contest either that such resignation was for Good Reason or its obligations to the Executive under Section 8(a) hereof.

(e) If the Executive's employment terminates after a Change of Control (as defined in Section 10 hereof), the payments to which he is entitled pursuant to Section 10 shall be in lieu of any payment to which he might otherwise be entitled under the terms of Section 8(a)(i). The benefits to which the Executive is entitled under Section 8(a)(ii) shall be payable whether or not his employment terminates after a Change of Control.

**9. RESIGNATION - TERMINATION FOR CAUSE - REGULATORY TERMINATION :**

(a) Notwithstanding the provisions of Section 1 of this Agreement, the Board of Directors of the Corporation may, in its sole discretion, terminate the Executive's employment for Cause. For the purposes of this Agreement, "Cause" shall mean personal dishonesty, incompetence, willful misconduct, breach of fiduciary duty involving personal profit, intentional failure to perform stated duties, willful violation of any law, rule, or regulation (other than traffic violations or similar offenses) or final cease-and-desist order, or material breach of any provision of this Agreement.

No act or omission to act by the Executive in reliance upon an opinion of counsel to the Corporation shall be deemed to be willful.

(b) Termination of the Executive's employment by the Corporation for Cause pursuant to Section 9(a) shall be communicated by written Notice of Termination to the Executive. A "Notice of Termination" shall mean a notice that shall indicate the specific termination provision(s) in this Agreement relied upon and shall set forth with particularity the facts and circumstances claimed to provide a basis for termination of employment for Cause under the provision so indicated.

If within ninety (90) days after any Notice of Termination is given the Executive notifies the Corporation that a dispute exists concerning the termination for Cause and that he is requesting arbitration pursuant to Section 18, the Corporation shall continue to pay the Executive his full salary and benefits as described in Sections 4 and 5, as and when due and payable, at least until such time as a final decision is reached by the panel of arbitrators. If a termination for Cause by the Corporation is challenged by the Executive and the termination is ultimately determined to be justified, then all sums paid by the Corporation to the Executive pursuant to this Section 9(b), plus the cost to the Corporation of providing the Executive such fringe benefits from the date of such termination to the date of the resolution of such dispute, shall be promptly repaid by the Executive to the Corporation with interest at the rate charged from time to time by the Corporation, to its most substantial customers for unsecured lines of credit. Should it ultimately be determined that a termination by the Corporation pursuant Section 9(a) was not



justified, then the Executive shall be entitled to retain all sums paid to him pending the resolution of such dispute and he shall be entitled to receive, in addition, the payments and other benefits provided for in Section 8(a).

A failure by the Executive to notify the Corporation that a dispute exists concerning the termination for Cause within ninety (90) days after the Notice of Termination is given shall constitute a final waiver by the Executive of his right to contest that such termination was for Cause.

(c) In the event that Executive resigns from or otherwise voluntarily terminates his employment by the Corporation at any time (except a termination for Good Reason pursuant to Section 8 hereto), or if the Corporation rightfully terminates the Executive's employment for Cause, this Agreement shall terminate upon the date of such resignation or termination of employment for Cause, and (subject to Section 9(b)) the Corporation thereafter shall have no obligation to make any further payments under this Agreement, provided that the Executive shall be entitled to receive any benefits, insured or otherwise, that he would otherwise be eligible to receive under any benefit plans of the Corporation,

(d) If Executive is suspended and/or temporarily prohibited from participating in the conduct of the Corporation's affairs by a notice served under Sections 8(e)(3) or 8(g)(1) [12 U.S.C. §§1818(e)(3) and 1818(g)(1)] of the Federal Deposit Insurance Act, 12 U.S.C. §1811 et seq. (the "Federal Deposit Insurance Act"), the Corporation's obligations under this Agreement shall be suspended as of the date of service unless stayed by appropriate proceedings. If the charges in the notice are dismissed, the Corporation may in its discretion (i) pay Executive all or part of the compensation withheld while its contract obligations were suspended, and (ii) reinstate (in whole or in part) any of its obligations which were suspended.

If Executive is removed and/or permanently prohibited from participating in the conduct of the Corporation's affairs by an order issued under Sections for 8(e)(4) of the Federal Deposit Insurance Act [12 U.S.C. §§1818(e)(4) or 1818(g)(1)], all obligations of the Corporation under this Agreement shall terminate as of the effective date of the order, but vested rights of the contracting parties shall not be affected.

If the Corporation is in default [as default is defined in Section 3(x)(1) of the Federal Deposit Insurance Act], all obligations under this Agreement shall terminate as of the date of default, but this paragraph shall not affect any vested rights of the contracting parties.

Except to the extent it is determined that continuation of this Agreement is necessary for the continued operation of the Corporation, all obligations under this Agreement shall be terminated:

(i) by the Director (as Director is defined in the Federal Deposit Insurance Act) or his or her designee, at the time the Federal Deposit Insurance enters into an agreement to provide assistance to or on behalf of the Corporation under the authority contained in Section 13(c) of the Federal Deposit Insurance Act; or

(ii) by the Director or his or her designee, at the time the Director or his or her designee approves a supervisory merger to resolve problems related to operation of the

Corporation or when the Corporation is determined by the Director to be in an unsafe or unsound condition.

Any rights of the parties that have already vested, however, shall not be affected by such action.

**10. CHANGE OF CONTROL :**

(a) If the Executive's employment terminates for any reason other than for Cause during the term of this Agreement and any renewal term following a Change of Control, the Corporation shall

(i) On or before the Executive's last day of employment with the Corporation (in addition to all other payments and benefits to which the Executive is entitled under any other contract) pay to the Executive as compensation for services rendered to it a cash amount (subject to any applicable payroll or other taxes required to be withheld) equal to two and ninety-nine hundredths (2.99) times the Executive's salary and bonus received during the twelve (12) months ending with the termination of the Executive's employment, provided that, at the option of the Executive, the cash amount required to be paid hereby shall be paid by the Corporation in equal monthly installments over the thirty-six (36) months succeeding the date of termination, payable on the first day of each such month; and

(ii) Maintain and provide for a period ending at the earlier of (i) two and ninety-nine hundredths (2.99) years after the date of termination or (ii) the date of the Executive's full time employment by another employer (provided that the Executive is entitled under the terms of such employment to benefits substantially similar to those described in this Subsection (a) (ii)), at no cost to the Executive, the Executive's continued participation in all group insurance, life insurance, health and accident, disability and other employee benefit plans, programs and arrangements in which the Executive was entitled to participate immediately prior to the date of termination (other than retirement plans or stock compensation plans of the Corporation.

(b) For purposes of this Agreement, a "Change of Control" shall mean (i) the acquisition by any "person" or "group" (as defined in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934 ("Exchange Act")), other than the Corporation, any subsidiary of the Corporation or any Corporation's or subsidiary's employee benefit plan, directly or indirectly, as "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act) of securities of the Corporation representing fifty percent (50%) or more of either the then outstanding shares or the combined voting power of the then outstanding securities of the Corporation; (ii) either majority of the directors of the Corporation elected at the Corporation's annual stockholders meeting shall have been nominated for election other than by or at the direction of the "incumbent directors" of the Corporation, or the "incumbent directors" shall cease to constitute a majority of the directors of the Corporation. The term "incumbent director" shall mean any director who was a director of the Corporation on April 1, 2001 and any individual who becomes a director of the Corporation subsequent to April 1, 2001 and who is elected or nominated by or at the direction of at least two-thirds of the then incumbent directors; (iii) the shareholders of the Corporation approve (iv) or other business combination of the Corporation with any other "person" or "group" (as defined in Sections 13(d) and 14(d) of the Exchange Act) or affiliate thereof; other than a merger or consolidation that would result in the outstanding common stock of the

Corporation immediately prior thereto continuing to represent either by remaining outstanding or by being converted into common stock of the surviving entity or a parent or affiliate thereof, at least fifty percent (50%) of the outstanding common stock of the Corporation or such surviving entity or a parent or affiliate thereof outstanding immediately after such merger, consolidation or other business combination, or (v) a plan of complete liquidation of the Corporation or an agreement for the sale or disposition by the Corporation of all or substantially all of the Corporation's assets; (vi) the resignation or removal of six directors within any sixty (60) consecutive day period; or (vii) any other event or circumstance which is not covered by the foregoing subsections but which the Board of Directors of the Corporation determines to affect control of the Corporation and with respect to which the Board of Directors adopts a resolution that the event or circumstance constitutes a Change of Control for purposes of the Agreement. Notwithstanding the foregoing, an acquisition by the Corporation of another corporation, a financial or structural reorganization of the Corporation, or the creation by the Corporation of a bank holding company of which it is a subsidiary shall not be considered to result in a change of control.

#### **11. LITIGATION – OBLIGATIONS - SUCCESSORS :**

(a) If litigation shall be brought or arbitration commenced to challenge, enforce or interpret any provision of this Agreement, and such litigation or arbitration does not end with judgment in favor of the Corporation, the Corporation hereby agrees to indemnify the Executive for his reasonable attorney's fees and disbursements incurred in such litigation or arbitration.

(b) The Corporation's obligation to pay the Executive the compensation and benefits and to make the arrangements provided herein shall be absolute and unconditional and shall not be affected by any circumstances, including, without limitation, any set-off counterclaim, recoupment, defense or other right which the Corporation may have against him or anyone else. All amounts payable by the Corporation hereunder shall be paid without notice or demand. Except as expressly provided in Sections 8(d) and 9(b), each and every payment made hereunder by the Corporation shall be final and the Corporation will not seek to recover all or any part of such payment from the Executive or from whosoever may be entitled thereto, for any reason whatsoever. The Executive shall not be required to mitigate the amount of any payment provided for in this Agreement by seeking other employment or otherwise; provided, if Executive secures other full time employment after a termination without Cause or a resignation for Good Reason (other than self employment or employment by an entity he owns or controls), the obligations of the Corporation under Section 8(a) shall be reduced dollar for dollar by the cash compensation received by the Executive from such other employment. This Section 11(b) shall not be interpreted to require or permit any reduction of benefits to which the Executive may be entitled under Section 10.

(c) The Corporation will require any successor (whether direct or indirect, by purchase, merger, consolidation or otherwise) to all or substantially all of the business and/or assets of the Corporation, or either one of them, by agreement in form and substance satisfactory to the Executive, to expressly assume and agree to perform this Agreement in its entirety. Failure of the Corporation to obtain such agreement prior to the effectiveness of any such succession shall be a breach of this Agreement and shall entitle the Executive to the compensation described in Section 8(a) or Section 10, as appropriate. As used in this Agreement, "Corporation" shall mean Southern Community Bank & Trust and any successor to

its business and/or assets as aforesaid which executes and delivers the agreement provided for in this Section 11(c) or which otherwise becomes bound by all the terms and provisions of this Agreement by operation of law.

**12. LIMITATION OF BENEFITS :** It is the intention of the parties that no payment be made or benefit provided to the Executive that would constitute an “excess parachute payment” within the meaning of Section 2806 of the Internal Revenue Code of 1986, as amended (the Code) and any regulations thereunder, thereby resulting in a loss of an income tax deduction by the Corporation or the imposition of an excise tax on Executive under Section 4999 of the Code. If the independent accountants serving as auditors for the Corporation immediately prior to the date of a Change of Control determine that some or all of the payments or benefits scheduled under this Agreement, when combined with any other payments or benefits provided to the Executive on a Change of Control by the Corporation and any affiliate of the Corporation required to be aggregated with the Corporation under Section 280G of the Code, would constitute nondeductible excess parachute payments by the Corporation under Section 280G of the Code, then the payments or benefits scheduled under this Agreement will be reduced to one dollar less than the maximum amount which may be paid or provided without causing any such payments or benefits scheduled under this Agreement or otherwise provided on a Change of Control to be nondeductible. The determination made as to the reduction of benefits or payments required hereunder by the independent accountants shall be binding on the parties. The Executive shall have the right to designate within a reasonable period which payments or benefits scheduled under this Agreement will be reduced; provided, however, that if no direction is received from the Executive, the Corporation shall implement the reductions under this Agreement in its discretion.

**13. NOTICES :** For the purposes of this Agreement, notices and all other communications provided for in the Agreement shall be in writing and shall be deemed to have been duly given when delivered or mailed by United States registered or certified mail, return receipt requested, postage prepaid, addressed as follows:

If to the Executive: Thomas W. Winfree  
P. O. Box 101  
The Plains, Virginia 20198

If to the Corporation: Southern Community Bank & Trust  
Attention: Chairman of the Board of Directors  
P. O. Box 330  
Midlothian, Virginia 23112

With a copy to:  
Craig D. Bell, Esquire  
McGuireWoods LLP  
901 East Cary Street  
Richmond, Virginia 23219-4030

or at such other address as any party may have furnished to the other in writing in accordance herewith, except that notices of change of address shall be effective only upon receipt.

**14. MODIFICATION - WAIVERS - APPLICABLE LAW :** No provisions of this Agreement may be modified, waived or discharged unless such waiver, modification or discharge is agreed to in writing, signed by the Executive and on behalf of the Corporation by such officer as may be specifically designated by the Board of Directors of the Corporation, No waiver by either party hereto at any time of any breach by the other party hereto of, or compliance with, any condition or provision of this Agreement to be performed by such other party shall be deemed a waiver of similar or dissimilar provision or conditions at the same or at any prior or subsequent time. No agreements or representations, oral or otherwise, express or implied, with respect to the subject matter hereof have been made by either party which are not set forth expressly in this Agreement. The validity, interpretation, construction and performance of this Agreement shall be governed by the laws of the State of Virginia.

**15. INVALIDITY - ENFORCEABILITY :** The invalidity or unenforceability of any provisions of this Agreement shall not affect the validity or enforceability of any other provision of this Agreement, which shall remain in full force and effect. Any provision in this Agreement which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective only to the extent of such prohibition or unenforceability without invalidating or affecting the remaining provisions hereof, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction.

**16. SUCCESSOR RIGHTS :** This Agreement shall inure to the benefit of and be enforceable by the Executive's personal or legal representatives, executors, administrators, successors, heirs, distributees, devisees and legatees. If Executive should die while any amounts would still be payable to him hereunder, all such amounts, unless otherwise provided herein, shall be paid in accordance with the terms of this Agreement to his executor or, if there is no such executor, to his estate.

**17. HEADINGS :** Descriptive headings contained in this Agreement are for convenience only and shall not control or affect the meaning or construction of any provision hereof.

**18. ARBITRATION :** Any dispute, controversy or claim arising under or in connection with this Agreement shall be settled exclusively by arbitration, conducted before a panel of three arbitrators, in Richmond, Virginia in accordance with the Commercial Arbitration Rules of the American Arbitration Association then in effect. The Corporation shall pay all administrative fees associated with such arbitration. Judgment may be entered on the arbitrator's award in any court having jurisdiction. Subject to Section 11(a), unless otherwise provided in the rules of the American Arbitration Association, the arbitrators shall, in their award, allocate between the parties the costs of arbitration, which shall include reasonable attorneys' fees and expenses of the parties, as well as the arbitrator's fees and expenses, in such proportions as the arbitrators deem just.

**19. CONFIDENTIALITY-NONSOLICITATION :**

(a) The Executive acknowledges that the Corporation may disclose certain confidential information to the Executive during the term of this Agreement to enable him to perform his duties hereunder. The Executive hereby covenants and agrees that he will not, without the prior written consent of the Corporation, during the term of this Agreement or at any time thereafter, disclose or permit to be disclosed to any third party by any method whatsoever any of the confidential information of the Corporation. For purposes of this Agreement, "confidential information" shall include, but not be limited to, any and all records, notes, memoranda, data, ideas, processes, methods, techniques, systems, formulas, patents, models, devices, programs, computer software, writings, research, personnel information, customer information, the Corporation's financial information, plans, or any other information of whatever nature in the possession or control of the Corporation which has not been published or disclosed to the general public, or which gives to the Corporation an opportunity to obtain an advantage over competitors who do not know of or use it. The Executive further agrees that if his employment hereunder is terminated for any reason, he will leave with the Corporation and will not take originals or copies of any and all records, papers, programs, computer software and documents and all matter of whatever nature which bears secret or confidential information of the Corporation.

The foregoing paragraph shall not be applicable if and to the extent the Executive is required to testify in a judicial or regulatory proceeding pursuant to an order of a judge or administrative law judge issued after the Executive and his legal counsel urge that the aforementioned confidentiality be preserved.

The foregoing covenants will not prohibit the Executive from disclosing confidential or other information to other employees of the Corporation or any third parties to the extent that such disclosure is necessary to the performance of his duties under this Agreement.

(b) Subject act to Section 19(c), during the term of this Agreement and throughout any future period that he is an officer or employee of the Corporation, and for a period of twelve (12) months from and after the termination of the last such position held by the Executive, or for a period of twelve (12) months from the date of entry by a court of competent

jurisdiction of a final judgment enforcing this covenant in the event of a breach by Executive, whichever is later, Employee covenants and agrees that he will not, without the prior written consent of the Corporation, solicit any existing or former customer or employee of the Corporation for any competing business regardless of its location.

(c) If the Corporation terminates the employment of the Executive without Cause or this Agreement terminates pursuant to Section 9(d), the covenant set forth in Section 19(b) shall not apply.

IN WITNESS WHEREOF, the parties have executed this Agreement effective as of the date first above written.

**“EXECUTIVE”**

ATTEST:

By: /s/ Thomas W. Winfree  
Thomas W. Winfree

Date: March \_\_, 2001

**SOUTHERN COMMUNITY BANK  
& TRUST**

ATTEST:

By: /s/ Craig D. Bell  
**AUTHORIZED OFFICER -**  
Craig D. Bell  
CHAIRMAN OF THE BOARD OF  
DIRECTORS

Date: March \_\_, 2001

**SOUTHERN COMMUNITY BANK & TRUST**

**INCENTIVE STOCK OPTION AGREEMENT**

THIS AGREEMENT dated as of the \_\_\_\_ day of \_\_\_\_\_, 200\_, between SOUTHERN COMMUNITY BANK & TRUST, a Virginia corporation (the “Company”), and \_\_\_\_\_ (“Optionee”), is made pursuant and subject to the provisions of the Company’s 2000 Incentive Plan (the “Plan”). All terms used herein that are defined in the Plan have the same meaning given them in the Plan.

WHEREAS, the Company has determined that it is in the best interest of the Company to provide an incentive to Optionee to acquire a proprietary interest in the Company and, as a stockholder, to share in its success, thus creating an added incentive for each Optionee to counsel and consult effectively for the Company and in the Company’s interest;

WHEREAS, the Company maintains the Plan;

WHEREAS, participation in the Plan is effected by an award of the Board of Directors and the execution of this Incentive Stock Option Agreement (the “Agreement”).



NOW, THEREFORE, in consideration of the mutual covenants hereafter set forth and for other good and valuable consideration, the parties hereby agree as follows:

1. Grant of Option . The Company hereby grants to Optionee as a matter of this separate Agreement and not in lieu of any other compensation, the right and option (hereafter called the “Option”), to purchase \_\_\_\_\_ (\_\_\_\_\_) whole shares of authorized, but unissued, common stock of the Company, on the terms and conditions herein set forth. The Option granted hereunder shall be exercisable by Optionee, subject to all terms and conditions set forth in the Plan and this Agreement. The Option is intended by the parties hereto to be, and shall be treated as, an incentive stock option (as such term is defined under Section 422 of the Internal Revenue of 1986).

2. Terms and Conditions . The Option is subject to the following terms and conditions:

(a) Price; Vesting and Expiration . The Option consists of one block. The following table sets forth the number of shares of Company Common Stock in the block; the per share purchase price of such shares; the date after which the Option is exercisable as to the shares in the block; and the date on which the Option expires as to the shares in the block.

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	Number of Shares	Purchase Price Per Share	Exercisable After	Expiration Date

- (b) Exercise of Option. Except as provided in paragraphs 3, 4 and 5, the Option is exercisable, in whole or in part, with respect to the total number of shares in the block as set forth above. To the extent the Option becomes exercisable, it shall continue to be exercisable until the earlier of termination of Optionee’s rights hereunder or until the Expiration Date. A partial exercise of the Option shall not affect Optionee’s right to exercise the Option with respect to the remaining shares, subject to the conditions of the Plan and this Agreement.
- (c) Method of Exercising and Payment for Shares. The Option shall be exercised by written notice delivered to the attention of the Company’s Secretary at the Company’s principal office in Midlothian, Virginia. The written notice shall specify the number of shares being acquired pursuant to the exercise of the Option when the Option is being exercised in part in accordance with subparagraph 2(b) hereof. The exercise date shall be the date such notice is received by the Company. Such notice shall be accompanied by payment of the option price in full for each share of Company Stock being acquired pursuant to such exercise, in cash (United States dollars) or cash equivalent acceptable to the Company, or, in whole or in part, through the surrender of previously acquired shares of Company Common Stock at their fair market value on the exercise date.
- (d) Cashless Exercise. To the extent permitted under the applicable laws and regulations, at the request of Optionee, the Company agrees to cooperate in a “cashless exercise” of the Option. The cashless exercise shall be effected by the Optionee delivering to a securities broker instructions to exercise all or part of the Option, including instructions to sell a sufficient number of shares of Common Stock to cover the costs and expenses associated therewith.
- (e) Nontransferability. The Option is nontransferable except by will or by the laws of descent and distribution. During Optionee’s lifetime, the Option may be exercised only by Optionee.

3. Termination of Service. (a) Except as provided in Sections 3(b) and 4, the Option shall lapse, terminate and be void if it is not exercised within ninety (90) days after any termination of Optionee’s employment by the Company.

(b) This Option may not be exercised after a termination of employment for cause. An exercise of the Option shall be ineffective if Optionee exercises at a time he or she has committed acts that would support a termination of employment for cause. For purposes of this

Agreement, “cause” shall mean dishonesty, fraud, willful misconduct or breach of fiduciary duty, as determined in the sole discretion of the Board of Directors.

4. Exercise in the Event of Death or Disability. The Option shall be exercisable in full in the event that prior to the Expiration Date of any block of the Option, the Optionee dies or becomes permanently and totally disabled while employed by the Company or an Affiliate. In the event of death, the Option may be exercised by Optionee’s estate, or the person or persons to whom his rights under the Option shall pass by will or the laws of descent and distribution. The Option shall continue to be exercisable for (x) the one year period beginning on the date the Optionee dies or terminates employment due to permanent and total disability, as the case may be, or (y) the remainder of the period preceding an Expiration Date set forth in Section 2(a), whichever is shorter.

5. Fractional Shares. Fractional shares shall not be issuable hereunder, and when any provision hereof may entitle Optionee to a fractional share, such fraction shall be disregarded.

6. No Right to Continued Employment. The Option does not confer upon Optionee any right with respect to continuance of employment by the Company, nor shall it interfere in any way with the right of the Company to terminate his employment.

7. Investment Representation. Optionee agrees that unless shares issuable under the Plan have been registered with the Securities and Exchange Commission and/or Federal Deposit Insurance Corporation, all shares purchased by him hereunder will be purchased for investment and not with a view to distribution or resale and until such registration, certificates representing such shares may bear an appropriate legend to assure compliance with applicable law and regulations.

8. Change in Capital Structure. The number of shares of Common Stock covered by the Option, and the price per share thereof, shall be proportionately adjusted for any increase or decrease in the number of issued shares of common stock of the Company resulting from a subdivision or consolidation of shares or the payment of a stock dividend (but only on the common stock), a stock split-up or any other increase or decrease in the number of such shares effected without receipt of cash or property or labor or services by the Company.

In the event of a change in the Common Stock of the Company as presently constituted, which is limited to a change of all of its authorized shares with par value into the same number of shares with a different par value or without par value, the shares resulting from any such change shall be deemed to be the Common Stock within the meaning of this Agreement.

To the extent that the foregoing adjustments relate to stock or securities of the Company, such adjustments shall be made by the Board, whose determination in that respect shall be final, binding and conclusive.

The grant of the Option pursuant to the Plan shall not affect in any way the right or power of the Company to make adjustments, reclassification, reorganizations or changes of its capital or

business structure or to merge or to consolidate or to dissolve, liquidate or sell, or transfer all or any part of its business or assets.

9. Notice. Optionee hereby promises to notify the Company in writing if, within two years of the date hereof or within one year of exercising this Option in whole or in part, he or she disposes of shares of Common Stock acquired under this Option.

10. Effect of Change in Control. If a tender offer or exchange offer for shares of Common Stock (other than such an offer by the Company) is commenced, or if the Shareholders of the Company shall approve an agreement providing either for a transaction in which the Company will cease to be an independent publicly-owned institution or for the sale or other disposition of all or substantially all of the assets of the Company, the Option shall (to the extent it is not then exercisable) become exercisable in full upon the happening of such event and shall remain so exercisable in accordance with the terms of the Option; provided, however, that this Section 10 shall not be deemed to cause this Option to be exercisable to the extent it previously been exercised or otherwise terminated.

11. Stockholder Rights Not Granted by This Option. The Optionee is not entitled by virtue hereof to any rights of a shareholder of the Company or to notice of meeting of shareholders or to notice of any other proceedings of the Company.

12. Withholding Tax. Where the Optionee or another person is entitled to receive shares of Common Stock pursuant to the exercise of this Option, the Company shall have the right to require the Optionee or such other person to pay to the Company the amount of any taxes which the Company is required to withhold with respect to such Option Shares, or, in lieu thereof, to retain, or sell without notice, a sufficient number of such shares to cover the amount required to be withheld from the Optionee's compensation payable by the Company to satisfy the Company's tax withholding requirements. The Company's method of satisfying its withholding obligations shall be solely in the discretion of the Company, subject to federal, state and local laws.

13. Notices. All notices hereunder to the Company shall be delivered or mailed to it addressed to the Secretary of Southern Community Bank & Trust, P.O. Box 330, Midlothian, Virginia 23113. Any notices hereunder to the Optionee shall be delivered personally or mailed to the Optionee's address noted below. Such addresses for the service of notices may be changed at any time provided written notice of the change is furnished in advance to the Company or to the Optionee, as the case may be.

14. Governing Law. This Agreement shall be governed by and construed and enforced in accordance with the laws of the Commonwealth of Virginia.

15. Conflicts. In the event of any conflict between the provisions of the Plan as in effect on the date hereof and the provisions of this Agreement, the provisions of the Plan shall govern. All references herein to the Plan shall mean the Plan as in effect on the date hereof.

16. Optionee Bound by Plan; Definitions. Optionee hereby acknowledges receipt of a copy of the Plan and agrees to be bound by all the terms and provisions thereof. Unless otherwise noted, defined terms used in this Agreement have the same meaning as provided in the Plan.

17. Binding Effect. Subject to the limitations stated above and in the Plan, this Agreement shall be binding upon and inure to the benefit of the legatees, distributees, and personal representatives of Optionee and the successors of the Company.

IN WITNESS WHEREOF, the Company has caused this Agreement to be signed by a duly authorized officer, and Optionee has affixed his signature hereto.

SOUTHERN COMMUNITY BANK & TRUST

By: \_\_\_\_\_  
Thomas W. Winfree, President & CEO

\_\_\_\_\_  
Optionee

**SOUTHERN COMMUNITY BANK & TRUST  
NON-EMPLOYEE DIRECTOR  
NON-QUALIFIED STOCK OPTION AGREEMENT**

THIS AGREEMENT dated as of \_\_\_\_\_, 200\_, between Southern Community Bank & Trust, a Virginia corporation (the "Company"), and \_\_\_\_\_ (the "Optionee"), is made pursuant and subject to the provisions of the Company's 2000 Incentive Plan, as amended from time to time (the "Plan"). All terms used herein that are defined in the Plan shall have the same meanings given them in the Plan.

1. Grant of Option. Pursuant to the terms of the Plan, the Company, on \_\_\_\_\_, 200\_, granted to the Optionee, subject to the terms and conditions of the Plan and subject further to the terms and conditions herein set forth, the right and option to purchase from the Company all or any part of an aggregate of \_\_\_\_\_ (\_\_\_\_\_) shares of the Common Stock of the Company (the "Common Stock") at an option price per share of \$\_\_\_\_\_ (the "Option"). The Option shall be a Non-Qualified Stock Option exercisable as hereinafter provided.

2. Terms and Conditions. This Option is subject to the following terms and conditions:  
(a) Expiration Date. The Expiration Date of this Option is \_\_\_\_\_, 201\_.  
(b) Exercise of Option. This Option shall be exercisable with respect to the total number of shares covered by this Option [at any time / at any time after \_\_\_\_\_, 200\_ and] until the earlier of the Expiration Date or the termination of the Optionee's rights hereunder pursuant to paragraph 3, 4 or 5. A partial exercise of this Option shall not affect the Optionee's right to exercise subsequently this Option with respect to the remaining shares that are exercisable, subject to the conditions of the Plan and this Agreement.

(c) Method of Exercising and Payment for Shares. This Option may be exercised only by written notice delivered to the attention of the Company's Secretary at the Company's principal office in Richmond, Virginia.

The written notice shall specify the number of shares being acquired pursuant to the exercise of the Option when such Option is being exercised in part in accordance with subparagraph 2(b) hereof. The exercise date shall be the date upon which such notice is received by the Company. Such notice shall be accompanied by payment of the Option price in full for each share either in cash in United States Dollars, or by the surrender of shares of Common Stock, or by cash equivalent acceptable to the Company or any combination thereof having an aggregate fair market value equal to the total Option price for all the shares being purchased.

(d) Cashless Exercise. To the extent permitted by applicable laws and regulations, at the request of the Optionee, the Company will cooperate in a "cashless exercise" in accordance with the Plan.

(e) Nontransferability. This Option is nontransferable except, in the event of the Optionee's death, by will or by the laws of descent and distribution, subject to the terms hereof. During the Optionee's lifetime, this Option may be exercised only by the Optionee.

3. Exercise in the Event of Death. This Option shall remain exercisable with respect to any shares yet unexercised in the event that the Optionee dies prior to exercising this Option in full and prior to the Expiration Date of this Option. In that event, this Option may be exercised by the Optionee's estate, or the person or persons to whom his rights under this Option shall pass by will or

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the laws of descent and distribution. The Optionee's estate or such persons must exercise this Option with respect to the remaining shares subject to the Option, if at all, within one year of the date of the Optionee's death or during the remainder of the period preceding the Expiration Date, whichever is shorter.

4. Exercise in the Event of Permanent and Total Disability . This Option shall remain exercisable with respect to any shares yet unexercised if the Optionee becomes permanently and totally disabled (as determined by the Board) while serving on the Board prior to exercising this Option in full and prior to the Expiration Date of this Option. In such event, the Optionee must exercise this Option with respect to the remaining shares subject to the Option, if at all, within one year of the date on which he ceases serving on the Board due to permanent and total disability or during the remainder of the period preceding the Expiration Date, whichever is shorter.

5. Exercise After Resignation, Non-Election or Other Approved Circumstance . In the event that the Optionee resigns from or is not re-elected or does not stand for re-election to the Board or in any other circumstance approved by the Board in its sole discretion, this Option shall remain exercisable with respect to any shares yet unexercised but must be exercised by the Optionee, if at all, within one year following the date of his resignation or cessation of service on the Board, or within the period prescribed by the Board in an approved circumstance, or during the remainder of the period preceding the Expiration Date, whichever is shorter.

6. Fractional Shares . Fractional shares shall not be issuable hereunder, and when any provision hereof may entitle the Optionee to a fractional share such fraction shall be disregarded.

7. Investment Representation . The Optionee agrees that, unless such shares shall previously have been registered under the Securities Act of 1933 or the rules and regulations of the Federal Deposit Insurance Corporation, if either of such registrations is required, (a) any shares purchased by him hereunder will be purchased for investment and not with a view to distribution or resale, and (b) until such registration, certificates representing such shares may bear an appropriate legend to assure compliance with such Act.

8. Change in Capital Structure . Subject to any required action by the shareholders of the Company, the number of shares of Common Stock covered by this Option, and the price per share thereof, shall be proportionately adjusted and its terms shall be adjusted as the Committee shall determine to be equitably required for any increase or decrease in the number of issued and outstanding shares of Common Stock of the Company resulting from any stock dividend (but only on the Common Stock), stock split, subdivision, combination, reclassification, recapitalization or general issuance to holders of Common Stock of rights to purchase Common Stock at substantially below its then fair market value or any change in the number of such shares outstanding effected without receipt of cash or property or labor or services by the Company or for any spin-off, spin-out, split-up, split-off or other distribution of assets to shareholders.

In the event of a change in the Common Stock of the Company as presently constituted, which is limited to a change of all of its authorized shares with par value or without par value, the shares resulting from any such change shall be deemed to be the Common Stock within the meaning of the Plan.

The grant of this Option pursuant to the Plan shall not affect in any way the right or power of the Company to make adjustments, reclassifications, reorganizations or changes of its capital or business structure or to merge or to consolidate or to dissolve, liquidate or sell, or transfer all or any part of its business or assets.

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9. Governing Law . This Agreement shall be governed by and construed and enforced in accordance with the laws of the Commonwealth of Virginia, except to the extent that federal law shall be deemed to apply.

10. Conflicts . In the event of any conflict between the provisions of the Plan as in effect on the date hereof and the provisions of this Agreement, the provisions of the Plan shall govern.

11. Optionee Bound by Plan . The Optionee hereby acknowledges receipt of a copy of the Plan and agrees to be bound by all the terms and provisions thereof.

12. Binding Effect . Subject to the limitations stated above and in the Plan, this Agreement shall be binding upon and insure to the benefit of the legatees, distributees, and personal representatives of the Optionee and the successors of the Company.

13. Counterparts . This Agreement may be executed in one or more counterparts, each one of which when so executed shall be deemed to be an original, and all of which taken together shall constitute one and the same agreement.

IN WITNESS WHEREOF, the Company has caused this Agreement to be signed by a duly authorized officer, and the Optionee has affixed his signature hereto.

OPTIONEE:

SOUTHERN COMMUNITY BANK & TRUST

\_\_\_\_\_

By: \_\_\_\_\_  
Thomas W. Winfree, President & CEO

Exhibit 21

**Subsidiaries of Southern Community Financial Corp.**

<u>Name of Subsidiary</u>	<u>State of Organization</u>
Village Bank	Virginia
Village Bank Mortgage Corporation (wholly-owned subsidiary of Village Bank)	Virginia
Village Insurance Agency, Inc. (wholly-owned subsidiary of Village Bank)	Virginia
Village Financial Services Corporation (wholly-owned subsidiary of Village Bank)	Virginia

Exhibit 31.1

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**



I, Thomas W. Winfree, certify that:

1. I have reviewed this annual report on Form 10-KSB of Southern Community Financial Corp.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the small business issuer as of, and for, the periods presented in this report;
4. The small business issuer's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the small business issuer and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) evaluated the effectiveness of the of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer 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: March 21, 2005

By: /s/ Thomas W. Winfree  
Thomas W. Winfree  
President and  
Chief Executive Officer

Exhibit 31.2

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, C. Harril Whitehurst, Jr., certify that:

1. I have reviewed this annual report on Form 10-KSB of Southern Community Financial Corp.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the small business issuer as of, and for, the periods presented in this report;
4. The small business issuer's other certifying officer and I are responsible for establishing and maintaining disclosure

controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the small business issuer and have:

- (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- (b) evaluated the effectiveness of the 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
- (a) 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 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: March 21, 2005

By: /s/ C. Harril Whitehurst, Jr.  
C. Harril Whitehurst, Jr.  
Senior Vice President and  
Chief Financial Officer

Exhibit 32

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

In connection with the Annual Report on Form 10-KSB of Southern Community Financial Corp. (the "Company") for the year ended December 31, 2004, the undersigned Chief Executive Officer and Chief Financial Officer of the Company 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 Form 10-KSB for the year ended December 31, 2004 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and (2) the information contained in the Form 10-KSB for the year ended December 31, 2004 fairly presents, in all material respects, the financial condition and results of operations of the Bank as of and for the periods presented.

/s/ Thomas W. Winfree  
Thomas W. Winfree  
Chief Executive Officer

March 21, 2005  
Date

/s/ C. Harril Whitehurst, Jr.  
C. Harril Whitehurst, Jr.

March 21, 2005  
Date

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**End of Filing**

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