

Southern Community Financial Corp.  
Form 10QSB  
May 16, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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

**For the quarterly period ended March 31, 2005**

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

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

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**Commission file number: 0-50765**

**SOUTHERN COMMUNITY FINANCIAL CORP.**

(Exact name of small business issuer as specified in its charter)

**Virginia**

**16-1694602**

(State or other jurisdiction of  
incorporation or organization)

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

**1231 Alverser Drive, P.O. Box 330, Midlothian, Virginia 23113**

(Address of principal executive offices)

**804-897-3900**

(Issuer's telephone number)

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 .

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

1,780,944 shares of common stock, \$4.00 par value, outstanding as of May 6, 2005.

**Southern Community Financial Corp.**

**Form 10-QSB**

**TABLE OF CONTENTS**

**Part I Financial Information**

**Item 1. Financial Statements**

Consolidated Statements of Financial Condition

March 31, 2005 (unaudited) and December 31, 2004 3

Consolidated Statements of Operations

For the Three Months Ended

March 31, 2005 and 2004 (unaudited) 4

Consolidated Statements of Stockholders' Equity

For the Three Months Ended

March 31, 2005 and 2004 (unaudited) 5

Consolidated Statements of Cash Flows

For the Three Months Ended

March 31, 2005 and 2004 (unaudited) 6

Notes to Condensed Consolidated Financial Statements (unaudited) 7

**Item 2. Management's Discussion and Analysis or Plan of Operation 10**

**Item 3. Controls and Procedures 25**

**Part II Other Information**

**Item 1. Legal Proceedings 26**

|  |    |
|--|----|
| <b>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</b> | 26 |
| <b>Item 3. Defaults Upon Senior Securities</b>                             | 26 |
| <b>Item 4. Submission of Matters to a Vote of Security Holders</b>         | 26 |
| <b>Item 5. Other Information</b>   | 26 |
| <b>Item 6. Exhibits</b>  | 26 |
| <b>Signatures</b>  | 27 |

**PART I FINANCIAL INFORMATION****ITEM 1 FINANCIAL STATEMENTS**

**Southern Community Financial Corp.**  
**Consolidated Statements of Financial Condition**  
**March 31, 2005 (unaudited) and December 31, 2004**

|   | March 31,<br>2005<br>(Unaudited) | December 31,<br>2004 |
|---|----------------------------------|----------------------|
| <b>Assets</b>                               |                                  |                      |
| Cash and due from banks                     | \$ 6,222,067                     | \$ 3,641,535         |
| Federal funds sold                          | 2,258,006                        | 4,957,872            |
| Investment securities available for sale    | 10,890,067                       | 5,427,604            |
| Loans held for sale                         | 3,535,927                        | 2,867,084            |
| Loans                                       |                                  |                      |
| Outstandings                                | 139,376,487                      | 136,006,900          |
| Allowance for loan losses                   | (1,601,782)                      | (1,514,029)          |
| Deferred fees                               | (251,925)                        | (330,578)            |
|   | 137,522,780                      | 134,162,293          |
| Premises and equipment, net                 | 6,271,445                        | 6,214,573            |
| Accrued interest receivable                 | 657,762                          | 610,866              |
| Goodwill                                    | 689,108                          | 689,108              |
| Other assets                                | 2,187,222                        | 1,733,939            |
|   | \$ 170,234,384                   | \$ 160,304,874       |
| <b>Liabilities and Stockholders' Equity</b> |                                  |                      |
| <b>Liabilities</b>                          |                                  |                      |
| Deposits                                    |                                  |                      |
| Noninterest bearing demand                  | \$ 13,146,650                    | \$ 10,030,927        |
| Now   | 8,375,321                        | 6,453,323            |
| Money market                                | 21,415,539                       | 24,000,555           |
| Savings                                     | 5,024,050                        | 4,437,962            |
| Time deposits of \$100,000 and over         | 28,922,688                       | 31,974,101           |
| Other time deposits                         | 66,382,121                       | 63,130,518           |

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|   |             |             |
|---|-------------|-------------|
|   | 143,266,369 | 140,027,386 |
| FHLB advances                               | 4,000,000   | 4,000,000   |
| Long-term debt - trust preferred securities | 5,155,000   | -           |
| Other borrowings                            | 1,926,926   | 835,079     |
| Accrued interest payable                    | 201,440     | 175,154     |
| Other liabilities                           | 365,418     | 282,096     |
| Total liabilities                           | 154,915,153 | 145,319,715 |

**Stockholders' equity**

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;

1,768,144 shares issued and outstanding at March 31, 2005,

1,761,744 shares issued and outstanding at December 31, 2004 7,072,576 7,046,976

Additional paid-in capital 8,655,428 8,615,748

Accumulated other comprehensive income (loss) (31,968) (31,798)

Retained earnings (deficit) (376,805) (645,767)

Total stockholders' equity 15,319,231 14,985,159

\$ 170,234,384 \$ 160,304,874

*See accompanying notes to consolidated financial statements.*

**Southern Community Financial Corp.**  
**Consolidated Statements of Operations**  
**For the Three Months Ended March 31, 2005 and 2004**  
**(Unaudited)**

|  | Three Months<br>Ended March 31, |              |
|--|---------------------------------|--------------|
|  | 2005                            | 2004         |
| <b>Interest income</b>                                 |                                 |              |
| Loans  | \$ 2,353,462                    | \$ 1,583,254 |
| Investment securities                                  | 49,729                          | 74,184       |
| Federal funds sold                                     | 48,173                          | 12,444       |
| Total interest income                                  | 2,451,364                       | 1,669,882    |
| <b>Interest expense</b>                                |                                 |              |
| Deposits   | 855,150                         | 542,009      |
| Borrowed funds   | 66,662                          | 58,499       |
| Total interest expense                                 | 921,812                         | 600,508      |
| Net interest income                                    | 1,529,552                       | 1,069,374    |
| Provision for loan losses                              | 90,533                          | 104,000      |
| Net interest income after provision<br>for loan losses | 1,439,019                       | 965,374      |
| <b>Noninterest income</b>                              |                                 |              |
| Service charges and fees                               | 133,292                         | 117,829      |
| Gain on sale of loans                                  | 282,725                         | 205,154      |
| Loss on securities, net                                | -                               | (16,396)     |
| Other  | 81,464                          | 14,258       |
| Total noninterest income                               | 497,481                         | 320,845      |
| <b>Noninterest expense</b>                             |                                 |              |
| Salaries and benefits                                  | 851,740                         | 726,412      |
| Occupancy  | 85,075                          | 68,272       |
| Equipment  | 116,329                         | 124,044      |
| Supplies   | 60,451                          | 42,038       |
| Professional and outside services                      | 207,423                         | 151,821      |

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|                                    |                   |                 |
|------------------------------------|-------------------|-----------------|
| Advertising and marketing          | 49,749            | 32,741          |
| Other operating expense            | 158,121           | 138,934         |
| Total noninterest expense          | 1,528,888         | 1,284,262       |
| Net income before income taxes     | 407,612           | 1,957           |
| Provision for income taxes         | 138,650           | -               |
| <b>Net income</b>                  | <b>\$ 268,962</b> | <b>\$ 1,957</b> |
| <b>Earnings per share, basic</b>   | <b>\$ 0.15</b>    | <b>\$ -</b>     |
| <b>Earnings per share, diluted</b> | <b>\$ 0.14</b>    | <b>\$ -</b>     |

*See accompanying notes to consolidated financial statements.*



**Southern Community Financial Corp.**  
**Consolidated Statements of Stockholders' Equity**  
**For The Three Months Ended March 31, 2005 and 2004**  
**(Unaudited)**

|  | Common Stock |              | Additional  | Accumulated   | Accumulated<br>Other |              |
|--|--------------|--------------|-------------|---------------|----------------------|--------------|
|  | Number of    | Amount       | Paid-in     | Deficit       | Comprehensive        | Total        |
|  | Shares       |              | Capital     |               | Income (loss)        |              |
| <b>Balance,<br/>December 31,<br/>2004</b>  | 1,761,744    | \$ 7,046,976 | \$8,615,748 | \$ (645,767)  | \$ (31,798)          | \$14,985,159 |
| Issuance of<br>common stock  | 6,400        | 25,600       | 39,680      | -             | -                    | 65,280       |
| Net income   | -            | -            | -           | 268,962       | -                    | 268,962      |
| Change in<br>unrealized gain<br>(loss) on<br>securities<br>available for<br>sale | -            | -            | -           | -             | (170)                | (170)        |
| Total<br>comprehensive<br>income (loss)  | -            | -            | -           | 268,962       | (170)                | 268,792      |
| <b>Balance,<br/>March 31,<br/>2005</b>   | 1,768,144    | \$ 7,072,576 | \$8,655,428 | \$ (376,805)  | \$ (31,968)          | \$15,319,231 |
| <b>Balance,<br/>December 31,<br/>2003</b>  | 1,710,994    | \$ 6,843,976 | \$8,303,810 | \$(1,507,310) | \$ (50,786)          | \$13,589,690 |
| Issuance of<br>common stock  | 1,200        | 4,800        | 4,728       | -             | -                    | 9,528        |
| Net income   | -            | -            | -           | 1,957         | -                    | 1,957        |
| Change in<br>unrealized gain<br>(loss) on<br>securities                          |              |              |             |               |                      |              |

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|                                |           |              |             |               |           |              |
|--------------------------------|-----------|--------------|-------------|---------------|-----------|--------------|
| available for sale             | -         | -            | -           | -             | 61,084    | 61,084       |
| Total comprehensive income     | -         | -            | -           | 1,957         | 61,084    | 63,041       |
| <b>Balance, March 31, 2004</b> | 1,712,194 | \$ 6,848,776 | \$8,308,538 | \$(1,505,353) | \$ 10,298 | \$13,662,259 |

*See accompanying notes to consolidated financial statements.*

**Southern Community Financial Corp.**  
**Consolidated Statements of Cash Flows**  
**For the Three Months Ended March 31, 2005 and 2004**  
**(Unaudited)**

|   | Three Months<br>Ended March 31, |              |
|---|---------------------------------|--------------|
|   | 2005                            | 2004         |
| <b>Cash Flows from Operating Activities</b>   |                                 |              |
| Net income  | \$ 268,962                      | \$ 1,957     |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                                 |              |
| Depreciation and amortization   | 81,164                          | 88,854       |
| Provision for loan losses   | 90,533                          | 104,000      |
| Gain on loans sold  | (282,725)                       | (205,154)    |
| Loss on securities  | -                               | 16,396       |
| Proceeds from sale of mortgage loans  | 11,996,152                      | 8,517,579    |
| Origination of mortgage loans for sale  | (12,382,270)                    | (8,485,996)  |
| Amortization of premiums and accretion of discounts on securities, net                      | 1,256                           | 4,170        |
| Increase in interest receivable   | (46,896)                        | (4,932)      |
| Increase in other assets  | (453,283)                       | (162,500)    |
| Increase in interest payable  | 26,286                          | 24,764       |
| Increase in other liabilities   | 83,322                          | 471,447      |
| Net cash provided by (used in) operating activities   | (617,499)                       | 370,585      |
| <b>Cash Flows from Investing Activities</b>   |                                 |              |
| Purchases of available for sale securities  | (8,806,000)                     | -            |
| Maturities of available for sale securities   | 3,342,111                       | 3,809,024    |
| Net increase in loans   | (3,451,020)                     | (11,543,680) |
| Purchases of premises and equipment   | (138,036)                       | (86,974)     |
| Net cash used in investing activities   | (9,052,945)                     | (7,821,630)  |
| <b>Cash Flows from Financing Activities</b>   |                                 |              |
| Issuance of common stock  | 65,280                          | 9,528        |

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|  |              |               |
|--|--------------|---------------|
| Net increase (decrease) in deposits                  | 3,238,983    | 18,322,595    |
| Proceeds from issuance of trust preferred securities | 5,155,000    | -             |
| Net increase in other borrowings                     | 1,091,847    | 68,565        |
| Net cash provided by financing activities            | 9,551,110    | 18,400,688    |
| Net increase (decrease) in cash and cash equivalents | (119,334)    | 10,949,643    |
| Cash and cash equivalents, beginning of period       | 8,599,407    | 5,564,441     |
| Cash and cash equivalents, end of period             | \$ 8,480,073 | \$ 16,514,084 |

*See accompanying notes to consolidated financial statements.*

## **Notes to Condensed Consolidated Financial Statements (Unaudited)**

### **Note 1 - Principles of presentation**

Southern Community Financial Corp. (the Company) is the holding company of Village Bank (the Bank). The consolidated financial statements include the accounts of the Company, the Bank and the Bank's three wholly-owned subsidiaries, Village Bank Mortgage Corporation, Village Insurance Agency, Inc., and Village Financial Services Corporation. All material intercompany balances and transactions have been eliminated in consolidation.

On April 26, 2005, the Company's shareholders approved the change of the Company's name to Village Bank and Trust Financial Corp. The name change will be effective upon the issuance by the Virginia State Corporation Commission of a certificate of amendment to the Company's articles of incorporation.

In the opinion of management, the accompanying condensed consolidated financial statements of the Company have been prepared on the accrual basis in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, all adjustments that are, in the opinion of management, necessary for a fair presentation have been included. The results of operations for the three month period ended March 31, 2005 is not necessarily indicative of the results to be expected for the full year ending December 31, 2005. The unaudited interim financial statements should be read in conjunction with the audited financial statements and notes to financial statements that are presented in the Bank's Annual Report on Form 10-KSB for the year ended December 31, 2004 as filed with the Securities and Exchange Commission.

### **Note 2 - Use of estimates**

The preparation of financial statements in conformity with generally accepted accounting principles 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 date of the statements of financial condition and revenues and expenses for the period. Actual results could differ significantly from those estimates.

**Note 3 - Earnings per common share**

Basic earnings per common share is computed by dividing the net earnings by the weighted-average number of common shares outstanding during the period, which totaled 1,763,841 and 1,711,601 for the three month periods ended March 31, 2005 and 2004, respectively. Diluted earnings per share reflects the potential dilution of securities that could share in the net earnings of the Company. Outstanding options and warrants to purchase common stock were considered in the computation of diluted earnings per share for the periods presented. During the three month periods ended March 31, 2005 and 2004, the weighted-average number of common shares on a fully diluted basis totaled 1,898,816 and 1,784,255, respectively. At March 31, 2005, there were options to acquire 31,350 shares of common stock that were anti-dilutive, and none that were anti-dilutive at March 31, 2004.

**Note 4 Stock incentive and stock 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 Bank. 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 March 31, 2005, 137,500 warrants had been issued and none had been exercised.

The Company has an Incentive Plan which authorizes the issuance of up to 255,000 shares of Common Stock to assist the Company in recruiting and retaining key personnel. The following table summarizes options outstanding under this plan:

|   | Three Months Ended March 31, |  |         |  |
|---|------------------------------|--|---------|--|
|   | 2005                         |  | 2004    |  |
|   | Options                      | Weighted<br>Average<br>Exercise<br>Price | Options | Weighted<br>Average<br>Exercise<br>Price |
| Options outstanding at beginning of period                | 197,410                      | \$ 9.14                                  | 160,900 | \$ 8.44                                  |
| Granted   | 500                          | 11.21                                    | 12,000  | 11.49                                    |
| Forfeited   | -                            | -  | (210)   | 8.80                                     |
| Exercised   | -                            | -  | -       | -  |
| Options outstanding at end of period                      | 197,910                      | \$ 9.15                                  | 172,690 | \$ 8.65                                  |
| Options exercisable at end of period                      | 123,060                      |  | 93,500  |  |
| Fair value per share of options granted during the period | \$ 4.30                      |  | \$ 2.69 |  |

The Company applies Accounting Principles Board Opinion 25 in accounting for stock options granted to employees and directors pursuant to the Incentive Plan. Had compensation expense been determined based upon the fair value of the awards at the grant date and consistent with the method under Statement of Financial Accounting Standards No. 123, the Company's net income for the periods indicated would have been decreased to the pro forma amounts indicated in the following table:





|                             | Three Months Ended March 31, |             |
|-----------------------------|------------------------------|-------------|
|                             | 2005                         | 2004        |
| Net income as reported      | \$ 268,962                   | \$ 1,957    |
| Options expense             | (22,000)                     | (17,000)    |
| Pro forma net income (loss) | \$ 246,962                   | \$ (15,043) |
| Net income (loss) per share |                              |             |
| Basic - as reported         | \$ 0.15                      | \$ -        |
| Basic - pro forma           | \$ 0.14                      | \$ (0.01)   |
| Diluted - as reported       | \$ 0.14                      | \$ -        |
| Diluted - pro forma         | \$ 0.13                      | \$ (0.01)   |

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

|                                | Three Months<br>Ended<br>March 31, 2005 |
|--------------------------------|---|
| Risk-free interest rate        | 4.5%                                    |
| Dividend yield                 | 0%                                      |
| Expected weighted average term | 7years                                  |
| Volatility                     | 25%                                     |

#### **Note 4 Trust preferred securities**

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, \$5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at March 31, 2005 was 5.16%. The securities may be redeemed at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. The principal asset of the Trust is \$5.2 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion. The portion of the Trust Preferred Capital Notes not considered as Tier 1 capital may be included in Tier 2 capital.

The obligations of the Company with respect to the issuance of the Trust Preferred Capital Notes constitute a full and unconditional guarantee by the Company of the Trust's obligations with respect to the Trust Preferred Capital Notes. Subject to certain exceptions and limitations, the Company may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related Trust Preferred Capital Notes and require a deferral of common dividends.

**ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**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:

- .  
interest rate fluctuations;
- .  
changes in laws and regulations applicable to us;
- .  
competition within and from outside the banking industry;
- .  
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;
- .  
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 general economic and business conditions;

.

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.

## **General**

The Company was organized under the laws of the Commonwealth of Virginia as a bank holding company whose activities consist of investment in its wholly-owned subsidiary, the Bank. The Bank is engaged in commercial and retail banking. We opened to the public on December 13, 1999. We place special emphasis on serving the financial needs of individuals, small and medium sized businesses, entrepreneurs, and professional concerns.

The Bank has three subsidiaries: Village Bank Mortgage Company, Village Insurance Agency, Inc., and Village Financial Services Corporation. Through our combined companies, 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 owned and 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 the customer. We conduct our operations from our main office/corporate headquarters location and four branch offices.

Our total assets increased to \$170,234,000 at March 31, 2005 from \$160,305,000 at December 31, 2004. The 6.2% increase in total assets during the first three months of 2005 resulted from the



growth of our business and customer base. However, this rate of growth is slower than we experienced in 2004.

While we expect growth to continue in 2005, it may not be at the higher rate experienced in 2004. Our expectation that our growth will continue in 2005 is based on our belief that the central Virginia economy is strong, with significant real estate activity which represents the largest source of lending for the Bank, and our past history of growth.

The following presents management's discussion and analysis of the financial condition of the Company at March 31, 2005 and December 31, 2004, and results of operations for the Company for the three month periods ended March 31, 2005 and 2004. This discussion should be read in conjunction with the Bank's Annual Report on Form 10-KSB for the year ended December 31, 2004 as filed with the Securities and Exchange Commission.

### **Results of operations**

We recorded net income of approximately \$269,000, or \$0.14 per share on a fully diluted basis, in the first quarter of 2005 compared to net income of approximately \$2,000, or less than \$0.01 per share, in the first quarter of 2004.

The improvement in our results of operations for the first quarter of 2005 of approximately \$267,000 over the results in 2004 was attributable primarily to our growth in loans and an improved net interest margin, as well as improved performance by Village Bank Mortgage. The Company's primary source of income, net interest income, increased by approximately \$460,000, or 43.0%, from \$1,069,000 in the first quarter of 2004 to \$1,529,000 in the first quarter of 2005. Noninterest income increased by approximately \$176,000, or 55.1%, from \$321,000 in the first quarter of 2004 to \$497,000 in the first quarter of 2005. This increase in noninterest income is primarily due to improved operations of Village Bank Mortgage and, to a lesser extent, increased income from Village Insurance Agency. We expect better operating results from both Village Bank Mortgage and Village Insurance Agency in 2005. Village Bank Mortgage has been successful in attracting new loan officers to generate higher loan volume, and management has reduced the overhead of Village Insurance Agency.

Noninterest expense increased by approximately \$245,000, or 19.0%, from \$1,284,000 in the first quarter of 2004 to \$1,529,000 in the first quarter of 2005. This increase in noninterest expense is attributable to our growth and expansion, with the majority of the increase in salaries and benefits of approximately \$125,000.

### **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 the three months ended March 31, 2005 and 2004 was approximately \$1,529,000 and \$1,069,000, respectively. This increase of \$460,000, or 43.0%, in net interest income was due to growth in loans and an improved net interest margin. Net loans increased by \$34,561,000, or 33.6%, from \$102,962,000 at March 31, 2004 to \$137,523,000 at March 31, 2005. In addition, our net interest margin for the first three months of 2005 was 4.06% compared to 3.88% for the first three months of 2004. This improvement in our net interest margin is due to the recent increases in the prime interest rate resulting from the increases in short-term interest rates by the Federal Reserve.

Average interest-earning assets for the first three months of 2005 increased by \$42,426,000, or 38.4%, compared to the first three months of 2004. The increase in interest-earning assets was due to the growth of our loan portfolio. The average yield on interest-earning assets increased to 6.50% for the first three months of 2005 compared to 6.07% for the first three months of 2004. The increase in the average yields from 2004 to 2005 was due primarily to an improvement in the yield on loans.

Our average interest-bearing liabilities increased by \$35,341,000, or 35.4%, for the first three months of 2005 compared to the first three months of 2004. The growth in those liabilities was primarily due to strong growth in deposits. The average cost of interest-bearing liabilities increased to 2.77% for the first three months of 2005 from 2.42% for the first three months of 2004. The principal reasons for the increase in the liability costs was the rise in short-term rates by the Federal Reserve discussed previously and an increase in our borrowing costs associated with the issuance of trust preferred securities. See our discussion of interest rate sensitivity below for more information.

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)**

|                                  | Three Months Ended March 31, 2005 |                                |                             | Three Months Ended March 31, 2004 |                                |                             |
|----------------------------------|-----------------------------------|--------------------------------|-----------------------------|-----------------------------------|--------------------------------|-----------------------------|
|                                  | Average<br>Balance                | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate | Average<br>Balance                | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate |
| Loans                            |                                   |                                |                             |                                   | \$                             |                             |
| Commercial                       | \$ 41,823                         | \$ 586                         | 5.68%                       | \$ 35,805                         | 567                            | 6.35%                       |
| Real estate -<br>residential     | 16,512                            | 267                            | 6.56%                       | 14,483                            | 210                            | 5.82%                       |
| Real estate -<br>commercial      | 45,228                            | 802                            | 7.19%                       | 18,253                            | 318                            | 6.99%                       |
| Real estate -<br>construction    | 31,081                            | 605                            | 7.89%                       | 26,587                            | 420                            | 6.34%                       |
| Consumer                         | 3,930                             | 70                             | 7.22%                       | 3,430                             | 56                             | 6.55%                       |
| Gross loans                      | 138,574                           | 2,330                          | 6.82%                       | 98,558                            | 1,571                          | 6.39%                       |
| Investment securities            | 4,666                             | 50                             | 4.35%                       | 5,584                             | 74                             | 5.32%                       |
| Loans held for sale              | 1,609                             | 23                             | 5.80%                       | 871                               | 12                             | 5.53%                       |
| Federal funds and<br>other       | 8,004                             | 48                             | 2.43%                       | 5,414                             | 13                             | 0.96%                       |
| Total interest earning<br>assets | 152,853                           | 2,451                          | 6.50%                       | 110,427                           | 1,670                          | 6.07%                       |
| Allowance for loan<br>losses     | (1,560)                           |                                |                             | (1,184)                           |                                |                             |
| Cash and due from<br>banks       | 5,583                             |                                |                             | 4,192                             |                                |                             |
| Premises and<br>equipment, net   | 6,242                             |                                |                             | 6,085                             |                                |                             |
| Other assets                     | 4,392                             |                                |                             | 1,924                             |                                |                             |
| Total assets                     | \$167,510                         |                                |                             | \$121,444                         |                                |                             |
| Interest bearing<br>deposits     |                                   |                                |                             |                                   |                                |                             |
| Interest checking                | \$ 7,458                          | \$ 17                          | 0.92%                       | \$ 4,869                          | \$ 11                          | 0.91%                       |
| Money market                     | 22,987                            | 105                            | 1.85%                       | 20,544                            | 71                             | 1.39%                       |
| Savings                          | 4,516                             | 12                             | 1.08%                       | 3,504                             | 10                             | 1.14%                       |
| Certificates                     | 95,889                            | 721                            | 3.05%                       | 65,586                            | 450                            | 2.75%                       |

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|   |           |          |       |           |          |       |
|---|-----------|----------|-------|-----------|----------|-------|
| Total deposits  | 130,850   | 855      | 2.65% | 94,503    | 542      | 2.30% |
| Borrowings  | 4,204     | 67       | 6.46% | 5,210     | 59       | 4.54% |
| Total interest bearing liabilities  | 135,054   | 922      | 2.77% | 99,713    | 601      | 2.42% |
| Noninterest bearing deposits  | 12,916    |          |       | 7,685     |          |       |
| Other liabilities   | 4,123     |          |       | 353       |          |       |
| Total liabilities   | 152,093   |          |       | 107,751   |          |       |
| Equity capital  | 15,417    |          |       | 13,693    |          |       |
| Total liabilities and capital   | \$167,510 |          |       | \$121,444 |          |       |
| Net interest income before provision for loan losses  |           | \$ 1,529 |       |           | \$ 1,069 |       |
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities |           |          | 3.73% |           |          | 3.65% |
| Annualized net interest margin (net interest income expressed as percentage of average earning assets)        |           |          | 4.06% |           |          | 3.88% |

### **Provision for loan losses**

The provision for loan losses for the three months ended March 31, 2005 was \$90,533, compared to \$104,000 for the three months ended March 31, 2004. The 12.9% decrease in 2005 was due to a smaller increase in loans in 2005 than in 2004. 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 increased significantly from \$321,000 for the first three months of 2004 to \$497,000 for the first three months in 2005, a \$176,000, or 55.1%, increase. This increase was directly attributable to improvement in the operations of the Bank's mortgage banking and insurance subsidiaries. Gains on loan sales increased from \$205,000 for the first three months of 2004 to \$283,000 for the first three months of 2005, a \$78,000, or 37.8%, increase. Other noninterest income increased from \$14,000 for the first three months of 2004 to \$81,000 for the first three months of 2005, a \$67,000, or 471.4%, increase.

### **Noninterest expense**

Noninterest expense for the three months ended March 31, 2005 totaled \$1,529,000, an increase of 19.0% from the \$1,284,000 recorded for the three months ended March 31, 2004. Salaries and benefits represented the largest increase, increasing by 17.3% for the first three months of 2005 to \$852,000, compared to \$726,000 for the first three months of 2004. This increase as well as other increases in noninterest expense were primarily attributable to the growth of the Bank. Audit and accounting expense increased by \$42,000, or 233.3%, for the three months ended March 31, 2005 compared to the same period in 2004 due to costs associated with compliance with the Sarbanes-Oxley Act of 2002.

### **Income taxes**

The provision for income taxes for the three months ended March 31, 2005 is based upon the results of operations. Certain items of income and expense are reported in different periods for financial reporting and tax return purposes. The tax effects of these temporary differences are recognized currently in the deferred income tax provision or benefit. Deferred tax assets or liabilities are computed based on the difference between the financial statement and income tax

bases of assets and liabilities using the applicable enacted marginal tax rate.

The Company must also evaluate the likelihood that deferred tax assets will be recovered from future taxable income. If any such assets are not likely to be recovered, a valuation allowance must be recognized. We have determined that a valuation allowance is not required for deferred tax assets as of March 31, 2005. The assessment of the carrying value of deferred tax assets is based on certain assumptions, changes in which could have a material impact on the Company's financial statements.

We did not record an income tax provision for the three months ended March 31, 2004 as we had a federal net operating loss carry forward of \$914,000 which offset taxable income. Also at March 31, 2004, we recorded a valuation allowance for the entire amount of the deferred tax asset as the timing and level of future earnings necessary to realize the deferred tax asset was uncertain at that time.

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 \$30,000 and \$26,500 for the three months ended March 31, 2005 and 2004, respectively.

### Loan portfolio

The following table presents the composition of our loan portfolio (excluding mortgage loans held for sale) at the dates indicated.

|                                 | <b>Loan Portfolio, Net</b> |               |                   |               |
|---------------------------------|----------------------------|---------------|-------------------|---------------|
|                                 | <b>(In thousands)</b>      |               |                   |               |
|                                 | March 31, 2005             |               | December 31, 2004 |               |
|                                 | Amount                     | %             | Amount            | %             |
| Commercial                      | \$ 36,406                  | 26.1%         | \$ 40,491         | 29.8%         |
| Real estate - residential       | 14,749                     | 10.6%         | 11,068            | 8.1%          |
| Real estate - commercial        | 52,472                     | 37.6%         | 45,121            | 33.2%         |
| Real estate - construction      | 26,788                     | 19.2%         | 30,870            | 22.7%         |
| Consumer                        | 8,962                      | 6.4%          | 8,457             | 6.2%          |
| <b>Total loans</b>              | <b>139,377</b>             | <b>100.0%</b> | <b>136,007</b>    | <b>100.0%</b> |
| Less: unearned income, net      | (252)                      |               | (331)             |               |
| Less: Allowance for loan losses | (1,602)                    |               | (1,514)           |               |
| <b>Total loans, net</b>         | <b>\$ 137,523</b>          |               | <b>\$ 134,162</b> |               |

### Allowance for loan losses

The allowance for loan losses at March 31, 2005 was \$1,602,000, compared to \$1,514,000 at December 31, 2004. The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) was 1.15% at March 31, 2005 as compared to 1.12% at December 31, 2004. 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. See our discussion of the allowance for loan losses under *Critical accounting policies* below.

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)**

|   | Three Months Ended March 31, |            |
|---|------------------------------|------------|
|   | 2005                         | 2004       |
| Beginning balance   | \$ 1,514                     | \$ 1,138   |
| Provision for loan losses   | 91                           | 104        |
| Charge-offs - consumer  | (4)                          |            |
| Recoveries  | 1                            | -          |
| Ending balance  | \$ 1,602                     | \$ 1,242   |
| Loans outstanding at end of period (1)  | \$ 139,125                   | \$ 104,204 |
| Ratio of allowance for loan losses as a percent of loans outstanding at end of period | 1.15%                        | 1.19%      |
| Average loans outstanding for the period (1)  | \$ 139,854                   | \$ 98,558  |
| Ratio of net charge-offs to average loans outstanding for the period                  | 0.00%                        | N/A        |

(1) Loans are net of unearned income.

**Investment portfolio**

At March 31, 2005 and December 31, 2004, 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**  
(*In thousands*)

|                             | Par<br>Value | Amortized<br>Cost | Unrealized<br>Gain<br>(Loss) | Estimated<br>Fair<br>Value | Average<br>Yield |
|-----------------------------|--------------|-------------------|------------------------------|----------------------------|------------------|
| <b>March 31, 2005</b>       |              |                   |                              |                            |                  |
| US Government Agencies      |              |                   |                              |                            |                  |
| Within one year             | \$ 8,605     | \$ 8,600          | \$ 1                         | \$ 8,601                   | 2.72%            |
| One to five years           | 500          | 512               | (10)                         | 502                        | 2.97%            |
| More than five years        | 1,200        | 1,200             | (50)                         | 1,150                      | 5.44%            |
| Total                       | 10,305       | 10,312            | (59)                         | 10,253                     | 3.05%            |
| Mortgage-backed securities  |              |                   |                              |                            |                  |
| More than five years        | 429          | 431               | 11                           | 442                        | 3.63%            |
| Total                       | 429          | 431               | 11                           | 442                        | 3.63%            |
| Other investments           |              |                   |                              |                            |                  |
| Within one year             | 145          | 145               | -                            | 145                        | 10.16%           |
| More than five years        | 50           | 50                | -                            | 50                         | 3.92%            |
|                             | 195          | 195               | -                            | 195                        | 8.56%            |
| Total investment securities | \$ 10,929    | \$ 10,938         | \$ (48)                      | \$ 10,890                  | 3.17%            |
| <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                       | 4,820        | 4,827             | (58)                         | 4,769                      | 2.57%            |



|                             |          |          |         |          |       |
|-----------------------------|----------|----------|---------|----------|-------|
| Mortgage-backed securities  |          |          |         |          |       |
| More than five years        | 450      | 453      | 10      | 463      | 3.62% |
| Total                       | 450      | 453      | 10      | 463      | 3.62% |
| Other investments           |          |          |         |          |       |
| Within one year             | 146      | 146      | -       | 146      | 5.50% |
| More than five years        | 50       | 50       |         | 50       | 3.92% |
|                             | 196      | 196      | -       | 196      | 5.10% |
| Total investment securities | \$ 5,466 | \$ 5,476 | \$ (48) | \$ 5,428 | 2.75% |

## 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.

Goodwill of \$689,000 at March 31, 2005 was related to the Bank's acquisition of Village Bank Mortgage in 2003.

## Deposits

Total deposits increased by \$3,239,000, or 2.3%, during the first three months of 2005 as compared to an increase of \$18,323,000, or 19.0%, during the first three months of 2004. In 2005, the increase in deposits resulted primarily from an increase of \$3,116,000 in noninterest demand accounts. This increase in noninterest demand accounts was due to the efforts of our two newest branches which were opened in late 2004. In 2004, the increase in deposits occurred primarily in noninterest demand accounts which increased by \$1,481,000, or 19.7%, and certificates of deposit which increased by \$16,026,000, or 26.6%.

The mix of our deposits continues to be weighted toward certificates of deposit which represent 66.5% of our total deposits at March 31, 2005 as compared to 67.9% at December 31, 2004. As a result, our cost of funds is higher than we would like and we are striving to change this mix more toward lower cost checking accounts. As our branch network increases and becomes more convenient to a larger segment of our targeted customer base, we believe that a move to a higher percentage of our deposits in checking accounts will occur. Additionally, we are emphasizing checking account deposit growth at our existing branches.

The average cost of interest-bearing deposits for the three months ended March 31, 2005 and 2004 was 2.65% and 2.30%, respectively. This increase in our average cost of interest-bearing deposits has mirrored the overall increase in interest rates resulting from the actions by the Federal Reserve to increase short-term interest rates.

The variety of deposit accounts that we offer 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 is expected to continue to be,

significantly affected by money market conditions.

### **Borrowings**

We use 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 of Atlanta ( FHLB ), 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 March 31, 2005 and December 31, 2004. The FHLB advances are secured by the pledge of U.S.

government agency securities and the pledge of 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 March 31, 2005 or December 31, 2004.

### Contractual obligations and other commitments

The following summarizes our contractual cash obligations and commitments, including maturing certificates of deposit, at March 31, 2005 and the effect such obligations may have on liquidity and cash flows in future periods.

#### Contractual Obligations (In thousands)

|                                 | Less Than<br>One Year | 1-3<br>Years | 3-5<br>Years | Over 5<br>Years | Total     |
|---------------------------------|-----------------------|--------------|--------------|-----------------|-----------|
| Leased property                 | \$ 88                 | \$ 106       | \$ 5         | \$ -            | \$ 199    |
| Time deposits (1)               | 51,245                | 26,615       | 17,445       | -               | 95,305    |
| FHLB advances                   | -                     | 4,000        | -            | -               | 4,000     |
| Other borrowings                | 1,927                 | -            | -            | -               | 1,927     |
| Undisbursed credit lines        | 35,618                | -            | -            | -               | 35,618    |
| Commitments to extend<br>credit | 14,921                | -            | -            | -               | 14,921    |
| Standby letters of credit       | 3,893                 | -            | -            | -               | 3,893     |
|                                 | \$107,692             | \$ 30,721    | \$ 17,450    | \$ -            | \$155,863 |

(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 March 31, 2005 was \$15,319,000, compared to \$14,985,000 at December 31, 2004. The \$334,000 increase in equity during the first three months of 2005 was due to proceeds from the issuance of common stock of \$65,000 and net income of \$269,000. The \$72,000 increase in equity during the first three months of 2004 was due to proceeds from the issuance of common stock of \$9,000, a \$61,000 increase in net unrealized losses on securities available-for-sale, and net income of \$2,000.

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

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

|  | March 31,<br>2005 | December 31,<br>2004 |
|--|-------------------|----------------------|
| <b>Tier 1 capital</b>                                |                   |                      |
| Common stock   | \$ 6,849          | \$ 7,047             |
| Additional paid-in capital                           | 8,308             | 8,616                |
| Trust preferred securities                           | 5,000             | -                    |
| Accumulated deficit                                  | (145)             | (646)                |
| Total equity   | 20,012            | 15,017               |
| Less: goodwill                                       | (689)             | (689)                |
| Total Tier 1 capital                                 | 19,323            | 14,328               |
| <b>Tier 2 capital</b>                                |                   |                      |
| Allowance for loan losses                            | 1,602             | 1,514                |
| Total Tier 2 capital                                 | 1,602             | 1,514                |
| Total risk-based capital                             | 20,925            | 15,842               |
| Risk-weighted assets                                 | \$ 154,150        | \$ 153,020           |
| Capital ratios                                       |                   |                      |
| Tier 1 capital to risk-weighted assets               | 12.5%             | 9.4%                 |
| Total capital to risk-weighted assets                | 13.6%             | 10.4%                |
| Leverage ratio (Tier 1 capital to<br>average assets) | 11.6%             | 9.4%                 |
| Equity to total assets                               | 11.7%             | 9.3%                 |

During the first quarter of 2005, the Company issued \$5.2 million in Trust Preferred Capital Notes to increase its regulatory capital and to help fund its expected growth in 2005. The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion.

## 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 March 31, 2005, cash, cash equivalents and investment securities available for sale totaled \$19,370,000, or 11.4% of total assets, which we believe is adequate to meet short-term liquidity needs.

At March 31, 2005, we had commitments to originate \$54,432,000 of loans. Fixed commitments to incur capital expenditures were less than \$25,000 at March 31, 2005. Certificates of deposit scheduled to mature in the 12-month period ending March 31, 2006 totaled \$51,245,000 at March

31, 2005. 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- 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 March 31, 2005. 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.





**Southern Community Bank & Trust**  
**Interest Rate Sensitivity GAP Analysis**  
**March 31, 2005**  
*(In thousands)*

|  | Within 3<br>Months | 3 to 6<br>Months | 6 to 12<br>Months | 13 to 36<br>Months | More<br>than<br>36<br>Months | Total    |
|--|--------------------|------------------|-------------------|--------------------|------------------------------|----------|
| <b>Interest Rate Sensitive Assets</b>      |                    |                  |                   |                    |                              |          |
| Loans (1)                                  |                    |                  |                   |                    |                              |          |
| Fixed rate                                 | \$ 1,547           | \$ 754           | \$ 5,126          | \$ 1,873           | \$ 3,636                     | \$12,936 |
| Variable rate                              | 88,439             | 3,743            | 4,697             | 15,188             | 14,373                       | 126,440  |
| Investment securities                      | 8,599              | 145              | -                 | 511                | 1,635                        | 10,890   |
| Loans held for sale                        | 3,536              | -                | -                 | -                  | -                            | 3,536    |
| Federal funds sold                         | 2,258              | -                | -                 | -                  | -                            | 2,258    |
| <br>                                       |                    |                  |                   |                    |                              |          |
| Total rate sensitive assets                | 104,379            | 4,642            | 9,823             | 17,572             | 19,644                       | 156,060  |
| Cumulative rate sensitive assets           | 104,379            | 109,021          | 118,844           | 136,416            | 156,060                      |          |
| <br>                                       |                    |                  |                   |                    |                              |          |
| <b>Interest Rate Sensitive Liabilities</b> |                    |                  |                   |                    |                              |          |
| Interest checking (2)                      | -                  | -                | -                 | 8,375              | -                            | 8,375    |
| Money market accounts                      | 21,416             | -                | -                 | -                  | -                            | 21,416   |
| Savings (2)                                | -                  | -                | -                 | 5,024              | -                            | 5,024    |
| Certificates of deposit                    | 17,286             | 15,993           | 18,094            | 26,488             | 17,445                       | 95,306   |
| FHLB advances                              | -                  | -                | -                 | 4,000              | -                            | 4,000    |
| Trust preferred securities                 | -                  | -                | -                 | -                  | 5,155                        | 5,155    |
| Other borrowings                           | 1,927              | -                | -                 | -                  | -                            | 1,927    |
| <br>                                       |                    |                  |                   |                    |                              |          |
| Total rate sensitive liabilities           | 40,629             | 15,993           | 18,094            | 43,887             | 22,600                       | 141,203  |
| Cumulative rate sensitive liabilities      | 40,629             | 56,622           | 74,716            | 118,603            | 141,203                      |          |

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|  |           |            |            |            |            |          |
|--|-----------|------------|------------|------------|------------|----------|
| Rate sensitivity gap for period  | \$ 63,750 | \$(11,351) | \$ (8,271) | \$(26,315) | \$ (2,956) | \$14,857 |
| Cumulative rate sensitivity gap  | \$ 63,750 | \$52,399   | \$44,128   | \$17,813   | \$14,857   |          |
| Ratio of cumulative gap to total assets  | 37.4%     | 30.8%      | 25.9%      | 10.5%      | 8.7%       |          |
| Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities | 256.9%    | 192.5%     | 159.1%     | 115.0%     | 110.5%     |          |
| Ratio of cumulative gap to cumulative rate sensitive assets                        | 61.1%     | 48.1%      | 37.1%      | 13.1%      | 9.5%       |          |

(1) Includes nonaccrual loans of \$1,237,000, 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 March 31, 2005, our assets that reprice within one year exceeded liabilities that reprice within one year by \$44,128,000 and therefore we were in an asset sensitive position. A positive gap can adversely affect earnings in periods of falling interest rates, but can improve earnings in periods of rising 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 our accounting policies. The selection and application of these accounting policies involve judgments, estimates, and uncertainties that are susceptible to change.

Presented below is a 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* filed with the Company's Annual Report on Form 10-KSB for the year ended December 31, 2004.

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan portfolio. 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 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 amounts of estimated impairment for individually evaluated loans and groups of loans are added together for a total estimate of loan losses. This estimate of losses is compared to our allowance for loan 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.

### **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 3 CONTROLS AND PROCEDURES**

Based upon an evaluation as of March 31, 2005 under the supervision and with the participation of 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, they have concluded that our disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934, as amended, are effective in ensuring that all material information required to be disclosed in reports that it files or submits under such Act are made known to them in a timely fashion.

Our management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in our 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.



**PART II OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

Not applicable.

**ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

**ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

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

Not applicable.

**ITEM 5 OTHER INFORMATION**

Not applicable.

**ITEM 6 EXHIBITS**

31.1

Certification of Chief Executive Officer

31.2

Certification of Chief Financial Officer

32.1

Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C.  
Section 1350



**SIGNATURES**

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

SOUTHERN COMMUNITY FINANCIAL CORP.

(Registrant)

Date: May 13, 2005

By: /s/ Thomas W. Winfree

Thomas W. Winfree

President and

Chief Executive Officer

Date: May 13, 2005

By: /s/ C. Harril Whitehurst, Jr. \_\_\_\_\_

C. Harril Whitehurst, Jr.

Senior Vice President and

Chief Financial Officer



**Exhibit Index**

Exhibit

Number

Document

31.1

Certification of Chief Executive Officer

31.2

Certification of Chief Financial Officer

32.1

Statement of Chief Executive Officer and Chief Financial Officer

Pursuant to 18 U.S.C. Section 1350