

Southern Community Financial Corp.
Form 10-Q
November 15, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended September 30, 2004

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

For the transition period from _____ to _____

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)

(Zip Code)

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:

1,745,744 shares of common stock, \$4.00 par value, outstanding as of November 8, 2004.

Southern Community Financial Corp.

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

Southern Community Financial Corp.
Consolidated Statements of Financial Condition
September 30, 2004 (unaudited) and December 31, 2003

| | September 30, 2004 (Unaudited) | December 31, 2003 |
|---|--------------------------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 5,794,776 | \$ 3,547,608 |
| Federal funds sold | 2,599,415 | 2,016,833 |
| Investment securities available for sale | 5,565,746 | 8,623,802 |
| Loans held for sale | 2,985,499 | 1,502,997 |
| Loans | | |
| Outstandings | 122,121,906 | 93,064,168 |
| Allowance for loan losses | (1,407,760) | (1,137,794) |
| Deferred fees | (360,819) | (403,867) |
| | 120,353,327 | 91,522,507 |
| Premises and equipment, net | 6,101,340 | 6,075,786 |
| Accrued interest receivable | 480,508 | 391,658 |
| Goodwill | 934,354 | 934,354 |
| Other assets | 711,265 | 443,958 |
| | \$ 145,526,230 | \$ 115,059,503 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits | | |
| Noninterest bearing demand | \$ 10,831,004 | \$ 7,522,220 |
| NOW | 5,739,917 | 4,686,374 |
| Money market | 20,847,708 | 20,570,001 |
| Savings | 4,364,509 | 3,279,538 |
| Time deposits of \$100,000 and over | 25,153,934 | 19,275,603 |
| Other time deposits | 55,312,418 | 40,988,871 |
| | 122,249,490 | 96,322,607 |

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| | | |
|--------------------------|-------------|-------------|
| FHLB advances | 4,000,000 | 4,000,000 |
| Other borrowings | 3,559,244 | 804,197 |
| Accrued interest payable | 150,177 | 114,177 |
| Other liabilities | 1,178,749 | 228,832 |
| Total liabilities | 131,137,660 | 101,469,813 |

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; 1,745,744 shares issued and outstanding at September 30, 2004, 1,710,994 shares issued and outstanding at December 31, 2003 | 6,982,976 | 6,843,976 |
| Additional paid-in capital | 8,516,548 | 8,303,810 |
| Accumulated other comprehensive income (loss) | (3,804) | (50,786) |
| Retained earnings (deficit) | (1,107,150) | (1,507,310) |
| Total stockholders' equity | 14,388,570 | 13,589,690 |
| | \$ 145,526,230 | \$ 115,059,503 |

See accompanying notes to consolidated financial statements.

Southern Community Financial Corp.
Consolidated Statements of Operations
Three and Nine Months Ended September 30, 2004 and 2003
(Unaudited)

| | Three Months | | Nine Months | |
|---|---------------------|--------------|---------------------|--------------|
| | Ended September 30, | | Ended September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| Interest income | | | | |
| Loans | \$ 1,832,222 | \$ 1,354,715 | \$ 5,198,375 | \$ 3,428,409 |
| Investment securities | 49,225 | 15,230 | 161,537 | 141,958 |
| Federal funds sold | 23,223 | 8,802 | 63,142 | 20,618 |
| Total interest income | 1,904,670 | 1,378,747 | 5,423,054 | 3,590,985 |
| Interest expense | | | | |
| Deposits | 641,807 | 477,642 | 1,805,993 | 1,303,024 |
| Borrowed funds | 42,648 | 63,235 | 149,004 | 136,776 |
| Total interest expense | 684,455 | 540,877 | 1,954,997 | 1,439,800 |
| Net interest income | 1,220,215 | 837,870 | 3,468,057 | 2,151,185 |
| Provision for loan losses | 206,484 | 100,000 | 367,384 | 347,000 |
| Net interest income after provision for loan losses | 1,013,731 | 737,870 | 3,100,673 | 1,804,185 |
| Noninterest income | | | | |
| Service charges and fees | 139,142 | 254,776 | 386,554 | 431,941 |
| Gain on sale of loans | 294,922 | 515,683 | 825,547 | 558,110 |
| Loss on securities, net | - | (43,783) | (26,370) | (55,042) |
| Other | 71,435 | 32,492 | 129,509 | 77,274 |
| Total noninterest income | 505,499 | 759,168 | 1,315,240 | 1,012,283 |
| Noninterest expense | | | | |

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| | | | | |
|------------------------------------|-------------------|-------------------|-------------------|-----------------|
| Salaries and benefits | 789,886 | 797,222 | 2,295,076 | 1,535,690 |
| Occupancy | 85,579 | 91,906 | 225,350 | 178,085 |
| Equipment | 108,791 | 90,557 | 343,111 | 234,519 |
| Data processing | 81,887 | 66,133 | 256,699 | 179,491 |
| Advertising and marketing | 25,451 | 36,066 | 91,710 | 86,576 |
| Supplies | 52,146 | 67,967 | 138,912 | 153,528 |
| Legal | 32,249 | 30,969 | 81,565 | 37,389 |
| Audit and accounting | 22,000 | 16,000 | 61,500 | 53,161 |
| Other outside services | 34,204 | 52,198 | 100,170 | 87,833 |
| Taxes other than income | 30,000 | 19,500 | 86,500 | 62,500 |
| Loan underwriting | 33,579 | 18,135 | 103,254 | 35,019 |
| Insurance expense | 255 | 10,904 | 4,280 | 39,701 |
| Telephone | 14,590 | 14,449 | 46,300 | 29,988 |
| Dues and memberships | 4,280 | 4,388 | 12,540 | 9,497 |
| Other operating expense | 65,303 | 40,463 | 168,786 | 92,200 |
| Total noninterest expense | 1,380,200 | 1,356,857 | 4,015,753 | 2,815,177 |
| Net income before income taxes | 139,030 | 140,181 | 400,160 | 1,291 |
| Provision for income taxes | - | - | - | - |
| Net income | \$ 139,030 | \$ 140,181 | \$ 400,160 | \$ 1,291 |
| Earnings per share, basic | \$ 0.08 | \$ 0.08 | \$ 0.23 | \$ 0.00 |
| Earnings per share, diluted | \$ 0.07 | \$ 0.08 | \$ 0.21 | \$ 0.00 |

See accompanying notes to consolidated financial statements.

Southern Community Financial Corp.
Consolidated Statements of Stockholders' Equity
Nine Months Ended September 30, 2004 and 2003
(Unaudited)

| | Common Stock | | Additional | | Accumulated | | Other | |
|---|--------------|-------------|-------------|---------------|---------------|----------|---------------|--------------|
| | Number | | Paid-in | Accumulated | Comprehensive | | Income (loss) | Total |
| | of | Amount | Capital | Deficit | | | | |
| | Shares | | | | | | | |
| Balance, December 31, 2003 | 1,710,994 | \$6,843,976 | \$8,303,810 | (1,507,310) | \$ | (50,786) | | \$13,589,690 |
| Issuance of common stock | 34,750 | 139,000 | 212,738 | - | | - | | 351,738 |
| Net income | - | - | - | 400,160 | | - | | 400,160 |
| Change in unrealized gain (loss) on securities available for sale | - | - | - | - | | 46,982 | | 46,982 |
| Total comprehensive income | - | - | - | 400,160 | | 46,982 | | 447,142 |
| Balance, September 30, 2004 | 1,745,744 | \$6,982,976 | \$8,516,548 | \$(1,107,150) | | (3,804) | | \$14,388,570 |
| Balance, December 31, 2002 | 1,697,294 | \$6,789,176 | \$8,246,325 | \$(1,576,135) | | 10,089 | | \$13,469,455 |
| Net income | - | - | - | 1,291 | | - | | 1,291 |
| Change in unrealized gain (loss) on securities available for sale | - | - | - | - | | 3,759 | | 3,759 |
| Total comprehensive income | - | - | - | 1,291 | | 3,759 | | 5,050 |
| | 1,697,294 | \$6,789,176 | \$8,246,325 | \$(1,574,844) | | 13,848 | | \$13,474,505 |

**Balance,
September 30,
2003**

*See accompanying notes to consolidated financial
statements.*

Southern Community Financial Corp.
Consolidated Statements of Cash Flows
For the Nine Months Ended September 30, 2004 and 2003
(Unaudited)

| | Nine Months Ended September 30, | |
|---|------------------------------------|--------------|
| | 2004 | 2003 |
| Cash Flows from Operating Activities | | |
| Net income | \$ 400,160 | \$ 1,291 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 260,136 | 197,183 |
| Provision for loan losses | 367,384 | 347,000 |
| Gain on loans sold | (825,547) | (558,110) |
| Loss on securities | 26,370 | 55,042 |
| Proceeds from sale of mortgage loans | 35,654,585 | 24,517,224 |
| Origination of mortgage loans for sale | (36,311,540) | (20,841,626) |
| Mortgage loans purchased | - | (5,740,531) |
| Amortization of premiums and accretion of discounts on securities, net | 18,280 | 8,769 |
| Increase in interest receivable | (88,850) | (25,128) |
| Increase in other assets | (267,307) | (185,285) |
| Increase in interest payable | 36,000 | 3,872 |
| Increase in other liabilities | 949,771 | 395,862 |
| Net cash provided by (used in) operating activities | 219,442 | (1,824,437) |
| Cash Flows from Investing Activities | | |
| Purchases of available for sale securities | (4,548,664) | (17,240,579) |
| Maturities of available for sale securities | 7,609,198 | 34,031,120 |
| Net increase in loans | (29,198,204) | (33,097,203) |
| Purchase of business | - | (934,354) |
| Purchases of premises and equipment | (285,690) | (2,101,757) |
| Net cash used in investing activities | (26,423,360) | (19,342,773) |
| Cash Flows from Financing Activities | | |
| Issuance of common stock | 351,738 | - |
| Net increase in deposits | 25,926,883 | 23,424,531 |
| Federal Home Loan Bank borrowings | - | 2,000,000 |

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| | | |
|--|--------------|--------------|
| Net increase in other borrowings | 2,755,047 | 1,100,000 |
| Net cash provided by financing activities | 29,033,668 | 26,524,531 |
| Net increase in cash and cash equivalents | 2,829,750 | 5,357,321 |
| Cash and cash equivalents, beginning of period | 5,564,441 | 3,537,429 |
| Cash and cash equivalents, end of period | \$ 8,394,191 | \$ 8,894,750 |

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 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 quarterly report for dates or periods prior to April 30, 2004 are references to the Bank.

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 and nine month periods ended September 30, 2004 are not necessarily indicative of the results to be expected for the full year ending December 31, 2004. 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, 2003 as filed with the Federal Deposit Insurance Corporation (the FDIC).

The consolidated statements include the Company's wholly owned subsidiary, the Bank, as well as the Bank's three wholly-owned subsidiaries, Community First Mortgage Corporation (Community First), Chippenham Insurance Agency, Inc. (Chippenham Insurance) and Southern Community Services, Inc. (Southern Community Services).

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 (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. During the three month periods ended September 30, 2004 and 2003, the weighted-average number of common shares outstanding totaled 1,729,336 and 1,697,294, respectively.

During the nine month periods ended September 30, 2004 and 2003, the weighted-average number of common shares outstanding totaled 1,717,732 and 1,697,294, 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 were considered in the computation of diluted earnings (loss) per share for the periods presented. For the three and nine months ended September 30, 2004, the weighted average number of common shares on a fully diluted basis totaled 1,914,763 and 1,929,242, respectively. For the three and nine months ended September 30, 2003, outstanding options and warrants had no effect on the computed earnings per share.

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 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 September 30, 2004, 137,500 warrants had been issued and none had been exercised.

The 2000 Stockholder Loan Referral Warrant Plan provided for the issuance of warrants to purchase up to 50,000 shares of Common Stock to shareholders who referred qualifying loans that are accepted by the Company from May 1, 2000 through April 30, 2003. The exercise price of each warrant was equal to the fair value of a share of Common Stock at the date of grant and each warrant had a twelve month term. During the nine months ended September 30, 2004, warrants to purchase 1,200 shares of Common Stock were exercised at a purchase price of \$7.94 per share. Total warrants issued under this plan amounted to 34,500, of which none remained outstanding at September 30, 2004. The value of the warrants issued is considered immaterial to the financial statements.

The Southern Community Financial Corp. Incentive Plan (the Incentive Plan) initially authorized the issuance of up to 175,000 shares of Common Stock to assist the Company in recruiting and retaining key personnel. At the Company's 2004 Annual Meeting held on June 29, 2004, the shareholders of the Company approved an amendment to the Incentive Plan increasing the number of shares issuable under the Incentive Plan to 255,000 shares of Common Stock. The following table summarizes options outstanding as of the indicated dates:

| | Options | Weighted Average Exercise Price |
|-------------------------------------|---------|---------------------------------------|
| Options outstanding January 1, 2004 | 160,900 | \$ 8.44 |
| Granted | 37,000 | 12.17 |
| Forfeited | (840) | 8.80 |
| Exercised | - | - |

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| | | | |
|--|---------|------|------|
| Options outstanding September 30, 2004 | 197,060 | \$ | 9.14 |
| Options exercisable September 30, 2004 | 122,610 | | |
| Fair value per share of options granted during the period | \$ | 4.99 | |

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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 (SFAS) 123, the Company's net income (loss) for the periods indicated would result in the pro forma amounts indicated in the following table:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------|----------------------------------|-----------|---------------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| Net income as reported | \$139,031 | \$140,181 | \$400,160 | \$1,291 |
| Options expense | (27,000) | (36,000) | (61,000) | (96,000) |
| Pro forma net income (loss) | \$112,031 | \$104,181 | \$339,160 | \$(94,709) |
| Net income (loss) per share | | | | |
| Basic - as reported | \$ 0.08 | \$ 0.08 | \$ 0.23 | \$ - |
| Basic - pro forma | \$ 0.06 | \$ 0.06 | \$ 0.20 | \$ (0.06) |
| Diluted - as reported | \$ 0.07 | \$ 0.08 | \$ 0.21 | \$ - |
| Diluted - pro forma | \$ 0.06 | \$ 0.06 | \$ 0.18 | \$ (0.06) |

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 Ended September 30, | |
|--------------------------------|----------------------------------|--------|
| | 2004 | 2003 |
| Risk-free interest rate | 4% | 4% |
| Dividend yield | 0% | 0% |
| Expected weighted average term | 7years | 7years |
| Volatility | 25% | 35% |

Note 5 Reclassifications

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

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:

.

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.

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: Community First, Chippenham Insurance, and Southern Community Services. 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 three branch offices.

Our total assets increased to \$145,526,000 at September 30, 2004 from \$115,060,000 at December 31, 2003. The 26.5% increase in total assets during the first nine months of 2004



resulted from the growth of our business and customer base. We believe this significant growth in total assets demonstrates the acceptance of our customer service philosophy by the community we serve.

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 the Share Exchange pursuant to 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 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.

The following presents management's discussion and analysis of the financial condition of the Company at September 30, 2004 and December 31, 2003, and results of operations for the Company for the three and nine month periods ended September 30, 2004 and 2003. This discussion should be read in conjunction with the Bank's Annual Report on Form 10-KSB for the year ended December 31, 2003 as filed with the Federal Deposit Insurance Corporation.

Results of operations

We recorded net income of approximately \$139,000, or \$0.07 per share on a fully diluted basis, in the third quarter of 2004 compared to net income of approximately \$140,000, or \$0.08 per share, in the third quarter of 2003. We recorded net income of approximately \$400,000, or \$0.21 per share on a fully diluted basis, for the nine months ended September 30, 2004, compared to net income of approximately \$1,000, or less than \$0.01 per share, for the nine months ended September 30, 2003.

While the Company's results of operations for the third quarter of 2004 of \$139,000 is similar to the \$140,000 earned in the third quarter of 2003, the makeup of the earnings differed. The Company's primary source of income, net interest income, increased by approximately \$382,000, or 45.6%, from \$838,000 in the third quarter of 2003 to \$1,220,000 in the third quarter of 2004. This increase in net interest income is a direct result of the Company's growth in loans and deposits. Noninterest income decreased by approximately \$254,000, or 33.4%, from \$759,000 in the third quarter of 2003 to \$505,000 in the third quarter of 2004. This decrease in noninterest income is attributable to decreases in service charges and fees of approximately \$116,000, or 45.4%, and gain on loan sales of approximately \$221,000, or 42.8%. These decreases in noninterest income are primarily due to the mortgage operations of Community First. In the third quarter of 2003 Community First had net income of \$93,000, while in the third quarter of 2004 Community First had a loss of \$99,000. This decline in the operations of Community First is primarily attributable to a decline in mortgage loan refinancings during 2004 which supported mortgage lending operations during 2003.

Noninterest expense increased slightly by approximately \$23,000, or 1.7%, from \$1,357,000 in the third quarter of 2003 to \$1,380,000 in the third quarter of 2004.

The improvement in the Company's results of operations for the nine months ended September 30, 2004 of approximately \$399,000 over the results for the same period in 2003 is attributable primarily to the Company's growth. The third quarter of 2003 was the first quarter the Company was profitable in its history, and it has sustained that profitability for each quarter since. Net interest income increased by approximately \$1,317,000, or 61.2%, from \$2,151,000 in the first nine months of 2003 to \$3,468,000 for the comparable period in 2004. This increase in net interest income is a direct result of the Company's growth in loans and deposits. Noninterest income increased by approximately \$303,000, or 29.9%, from \$1,012,000 for the nine months ended September 30, 2003

to \$1,315,000 for the nine months ended September 30, 2004. This increase in noninterest income is attributable primarily to an increase in gain on loan sales of approximately \$267,000, or 47.9% resulting from the mortgage operations of Community First. Community First was acquired on June 30, 2003 and only three months of its operations were included in the consolidated results of the Company in 2003 compared to the first nine months in 2004.

Noninterest expense increased by approximately \$1,201,000, or 42.6%, from \$2,815,000 in the first nine months of 2003 to \$4,016,000 in the same period in 2004. This increase in noninterest expense is attributable to our growth and expansion, including the acquisition of Community First, with the majority of the increase in salaries and benefits of approximately \$759,000.

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 nine months ended September 30, 2004 and 2003 was approximately \$3,468,000 and \$2,151,000, respectively. This increase of \$1,317,000, or 61.2%, in net interest income was due to growth in loans and deposits. Our net interest margin for the first nine months of 2004 was 3.85% compared to 3.59% for the first nine months of 2003.

Average interest-earning assets for the first nine months of 2004 amounted to \$120,374,000, an increase of \$40,171,000, or 50.1%, over the \$80,203,000 amount for the first nine months of 2003. The increase in interest-earning assets was due to the growth of our loan portfolio. The average yield on interest-earning assets for the first nine months of 2004 increased slightly to 6.02% compared to 5.99% for the first nine months of 2003. However, the yield on loans declined from 6.75% for the first nine months of 2003 to 6.45% for the first nine months of 2004. This decrease was offset in part by an increase in the yield on investments from 2.02% for the first nine months of 2003 to 4.36% for the first nine months of 2004.

Average interest-bearing liabilities for the first nine months of 2004 amounted to \$108,698,000, an increase of \$39,324,000, or 56.7%, over the \$69,374,000 amount for the first nine months of 2003. The growth in average interest-bearing liabilities was primarily due to strong growth in deposits. The average cost of interest-bearing liabilities declined to 2.40% for the first nine months of 2004 from 2.78% for the first nine months of 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 3.21% in the first nine months of 2003 to 2.74% in the first nine months of 2004. Most of our deposit liabilities are fixed-rate certificates, so declining market short-term rates in the past year have had a positive impact on our net interest income. In addition, our average non-interest-bearing deposits increased from \$4,992,000

for the first nine months of 2003 to \$8,735,000 for the first nine months of 2004. In the third quarter of 2004, the Board of Governors of the Federal Reserve System (the Federal Reserve) continued to increase short-term interest rates and further increases are expected in the last quarter of 2004. As a result, the average cost of our interest-bearing deposits is expected to increase. 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.

(Dollars in thousands)

| | Nine Months Ended September 30, 2004 | | | Nine Months Ended September 30, 2003 | | |
|---------------------------------------|--------------------------------------|--------------------------------|-----------------------------|--------------------------------------|--------------------------------|-----------------------------|
| | Average Balance | Interest Income/ Expense | Annualized Yield Rate | Average Balance | Interest Income/ Expense | Annualized Yield Rate |
| Loans | | | | | | |
| Commercial | \$37,463 | \$1,660 | 5.92% | \$29,999 | \$1,461 | 6.51% |
| Real estate - residential | 14,557 | 684 | 6.28% | 12,737 | 628 | 6.59% |
| Real estate - commercial | 22,565 | 1,199 | 7.10% | 8,792 | 489 | 7.44% |
| Real estate - construction | 28,388 | 1,418 | 6.67% | 11,843 | 600 | 6.77% |
| Consumer | 3,417 | 180 | 7.04% | 3,736 | 212 | 7.59% |
| Gross loans | 106,390 | 5,141 | 6.45% | 67,107 | 3,390 | 6.75% |
| Investment securities | 4,960 | 162 | 4.36% | 9,419 | 142 | 2.02% |
| Loans held for sale | 1,392 | 57 | 5.47% | 1,193 | 38 | 4.26% |
| Federal funds and other | 7,632 | 63 | 1.10% | 2,484 | 21 | 1.13% |
| Total interest earning assets | 120,374 | 5,423 | 6.02% | 80,203 | 3,591 | 5.99% |
| Allowance for loan losses | (1,228) | | | (912) | | |
| Cash and due from banks | 4,416 | | | 3,387 | | |
| Premises and equipment, net | 6,082 | | | 4,417 | | |
| Other assets | 1,993 | | | 1,316 | | |
| Total assets | \$131,637 | | | \$88,411 | | |
| Interest bearing deposits | | | | | | |
| Interest checking | \$5,149 | \$ 36 | 0.93% | \$ 3,570 | \$ 28 | 1.05% |
| Money market | 20,525 | 216 | 1.41% | 13,024 | 153 | 1.57% |
| Savings | 3,750 | 32 | 1.14% | 3,299 | 31 | 1.26% |
| Certificates | 74,264 | 1,522 | 2.74% | 45,493 | 1,091 | 3.21% |
| Total deposits | 103,688 | 1,806 | 2.33% | 65,386 | 1,303 | 2.66% |
| Borrowings | 5,010 | 149 | 3.97% | 3,988 | 137 | 4.59% |
| Total interest bearing liabilities | 108,698 | 1,955 | 2.40% | 69,374 | 1,440 | 2.78% |

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| | | |
|-------------------------------|-----------|-----------|
| Noninterest bearing deposits | 8,735 | 4,992 |
| Other liabilities | 325 | 658 |
| Total liabilities | 117,758 | 75,024 |
| Equity capital | 13,879 | 13,387 |
| Total liabilities and capital | \$131,637 | \$ 88,411 |

| | | |
|--|---------|----------|
| Net interest income before provision for loan losses | \$3,468 | \$ 2,151 |
|--|---------|----------|

| | | |
|---|-------|-------|
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities | 3.62% | 3.21% |
|---|-------|-------|

| | | |
|--|-------|-------|
| Annualized net interest margin (net interest income expressed as percentage of average earning assets) | 3.85% | 3.59% |
|--|-------|-------|

Provision for loan losses

The provision for loan losses for the nine months ended September 30, 2004 was \$367,000, compared to \$347,000 for the nine months ended September 30, 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 increased significantly from \$1,012,000 for the first nine months of 2003 to \$1,315,000 for the first nine months in 2004, a \$303,000, or 29.9%, increase. This increase in noninterest income is due to the mortgage operations of Community First. Community First was acquired on June 30, 2003 and only three months of its operations were included in the consolidated results of the Company in 2003 compared to nine months in 2004. Gains on loan sales increased from \$558,000 for the first nine months of 2003 to \$826,000 for the first nine months of 2004, a \$268,000, or 47.9%, increase.

Noninterest expense

Noninterest expense for the nine months ended September 30, 2004 totaled \$4,016,000, an increase of 42.6% from the \$2,815,000 recorded for the nine months ended September 30, 2003. Salaries and benefits represented the largest increase, increasing by 49.4% for the first nine months of 2004 to \$2,295,000, compared to \$1,536,000 for the first nine months of 2003. This increase as well as other increases in noninterest expense were primarily attributable to the acquisition of Community First and the addition of two branches and staff.

Income taxes

We did not record any income tax expense for the nine months ended September 30, 2004 and 2003. At December 31, 2003, we had a federal net operating loss carry forward of \$914,000, portions of which expire on various dates through 2023. We have 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 are uncertain.

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 \$86,500 and \$62,500 for the nine months ended September 30, 2004 and 2003, respectively.

Loan portfolio

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

Loan Portfolio, Net
(Dollars in thousands)

| | September 30, 2004 | | December 31, 2003 | |
|---------------------------------|--------------------|--------|-------------------|--------|
| | Amount | % | Amount | % |
| Commercial | \$ 39,489 | 32.3% | \$ 32,822 | 35.4% |
| Real estate - residential | 14,883 | 12.2% | 14,279 | 15.3% |
| Real estate - commercial | 36,296 | 29.7% | 16,500 | 17.7% |
| Real estate - construction | 27,470 | 22.5% | 25,627 | 27.5% |
| Consumer | 3,984 | 3.3% | 3,836 | 4.1% |
| | | | | |
| Total loans | 122,122 | 100.0% | 93,064 | 100.0% |
| Less: unearned income, net | (361) | | (404) | |
| Less: Allowance for loan losses | (1,408) | | (1,138) | |
| | | | | |
| Total loans, net | \$ 120,353 | | \$ 91,522 | |

Allowance for loan losses

The allowance for loan losses at September 30, 2004 was \$1,408,000, compared to \$1,138,000 at December 31, 2003.

The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) was 1.16% at September 30, 2004 as compared to 1.23% at December 31, 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. 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
(Dollars in thousands)

| | Nine Months Ended September 30, | |
|---|---------------------------------|-----------|
| | 2004 | 2003 |
| Beginning balance | \$ 1,138 | \$ 755 |
| Provision for loan losses | 367 | 347 |
| Acquisition of mortgage company | - | 40 |
| Charge-offs - commercial | (99) | (56) |
| Recoveries | 2 | - |
| Ending balance | \$ 1,408 | \$ 1,086 |
| Loans outstanding at end of period (1) | \$ 121,761 | \$ 83,794 |
| Ratio of allowance for loan losses as a percent of loans outstanding at end of year | 1.16% | 1.30% |
| Average loans outstanding for the period (1) | \$ 106,390 | \$ 67,107 |
| Ratio of net charge-offs to average loans outstanding for the period | 0.09% | 0.08% |

(1) Loans are net of unearned income.

Investment portfolio

At September 30, 2004 and December 31, 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 |
|-----------------------------|--------------|-------------------|------------------------------|----------------------------|------------------|
| September 30, 2004 | | | | | |
| US Government Agencies | | | | | |
| Within one year | \$ 1,811 | \$1,804 | \$ (2) | \$1,802 | 1.67% |
| One to five years | 500 | 515 | (5) | 510 | 2.97% |
| More than five years | 2,500 | 2,500 | (9) | 2,491 | 5.21% |
| Total | 4,811 | 4,819 | (16) | 4,803 | 3.64% |
| Mortgage-backed securities | | | | | |
| More than five years | 551 | 555 | 12 | 567 | 3.66% |
| Total | 551 | 555 | 12 | 567 | 3.66% |
| Other investments | | | | | |
| Within one year | 146 | 146 | - | 146 | 10.16% |
| More than five years | 50 | 50 | - | 50 | 3.92% |
| | 196 | 196 | - | 196 | 8.56% |
| Total investment securities | \$5,558 | \$5,570 | \$ (4) | \$5,566 | 3.82% |
| December 31, 2003 | | | | | |
| 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 | 7,250 | 7,292 | (65) | 7,227 | 3.48% |
| Mortgage-backed securities | | | | | |

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| | | | | | |
|-----------------------------|---------|----------|---------|----------|-------|
| More than five years | 1,316 | 1,333 | 14 | 1,347 | 4.06% |
| Total | 1,316 | 1,333 | 14 | 1,347 | 4.06% |
| Other investments | | | | | |
| More than five years | 50 | 50 | - | 50 | 3.92% |
| Total investment securities | \$8,616 | \$ 8,675 | \$ (51) | \$ 8,624 | 3.57% |

Goodwill

On June 30, 2003, we purchased for cash all of the outstanding shares of Community First. Community First is based in Richmond, Virginia and has a loan production office in Verona, Virginia. The former owner of Community First is Community Bank of Staunton, Virginia. The purchase resulted in the recording of goodwill of \$689,000.

On January 1, 2003, we purchased for cash all of the outstanding shares of Chippenham Insurance, a full-service insurance agency that has been doing business in Chesterfield County, Virginia for 22 years. The purchase resulted in the recording of goodwill of \$245,000.

Deposits

Total deposits increased by \$25,927,000, or 26.9%, for the first nine months of 2004 as compared to an increase of \$23,424,000, or 36.3%, for the first nine months of 2003. During the first nine months of 2004, the increase in deposits occurred primarily in noninterest demand accounts which increased by \$3,309,000, or 44.0%, and certificates of deposit which increased by \$20,202,000, or 33.5%.

The mix of our deposits continues to be weighted toward certificates of deposit which represent 65.8% of our total deposits at September 30, 2004 as compared to 62.6% at December 31, 2003. 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 through advertising and new checking account products.

The average cost of interest-bearing deposits for the nine months ended September 30, 2004 and 2003 was 2.33% and 2.66%, respectively. This decline in our average cost of interest-bearing deposits has mirrored the overall decline in interest rates resulting from the actions by the Federal Reserve to decrease short-term interest rates during 2003. However, in the second quarter of 2004, the Federal Reserve increased short-term interest rates by .25% and further increases will occur in the last quarter of 2004. As a result, the average cost of our interest-bearing deposits is expected to increase.

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 we expect it will 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. Outstanding borrowings from the FHLB were \$4,000,000 at September 30, 2004 and December 31, 2003. The FHLB advances are secured by the pledge of U.S. government agency securities, our residential mortgage loans, and our FHLB stock.

Federal funds purchased represent unsecured borrowings from other banks and generally mature daily. We had outstanding federal funds purchased of \$2,875,000 at September 30, 2004 and none at December 31, 2003.

Contractual obligations and other commitments

The following summarizes our contractual cash obligations and commitments, including maturing certificates of deposit, at September 30, 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 | 2-3 Years | 4-5 Years | Over 5 Years | Total |
|------------------------------|-----------------------|--------------|--------------|-----------------|------------|
| Leased property | \$ 54 | \$ 111 | \$ 54 | \$ 57 | \$ 276 |
| Time deposits (1) | 50,013 | 20,313 | 10,137 | 3 | 80,466 |
| FHLB advances | - | - | 4,000 | - | 4,000 |
| Other borrowings | 3,559 | - | - | - | 3,559 |
| Undisbursed credit lines | 35,982 | - | - | - | 35,982 |
| Commitments to extend credit | 4,971 | - | - | - | 4,971 |
| Standby letters of credit | 3,186 | - | - | - | 3,186 |
| | \$ 97,765 | \$ 20,424 | \$ 14,191 | \$ 60 | \$ 132,440 |

(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 September 30, 2004 was \$14,389,000, compared to \$13,590,000 at December 31, 2003. The \$799,000 increase in equity during the first nine months of 2004 was due to proceeds from the issuance of stock of \$352,000, a \$47,000 decrease in net unrealized losses on securities available-for-sale and net income of \$400,000. The \$5,000 increase in equity during the first nine months of 2003 was due to a \$4,000 increase in net unrealized gains on securities available-for-sale, and net income of \$1,000.

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

Analysis of Capital
(Dollars in thousands)

| | September 30, 2004 | December 31, 2003 |
|---|-----------------------|----------------------|
| Tier 1 capital | | |
| Common stock | \$ 6,983 | \$ 6,844 |
| Additional paid-in capital | 8,517 | 8,304 |
| Accumulated deficit | (1,107) | (1,507) |
| Total equity | 14,393 | 13,641 |
| Less: goodwill | (934) | (934) |
| Total Tier 1 capital | 13,459 | 12,707 |
| Tier 2 capital | | |
| Allowance for loan losses | 1,408 | 1,138 |
| Total Tier 2 capital | 1,408 | 1,138 |
| Total risk-based capital | 14,867 | 13,845 |
| Risk-weighted assets | \$ 136,260 | \$ 99,643 |
| Capital ratios | | |
| Leverage ratio (Tier 1 capital to average assets) | 9.8% | 11.4% |
| Tier 1 capital to risk-weighted assets | 9.9% | 12.8% |
| Total capital to risk-weighted assets | 10.9% | 13.9% |
| Equity to total assets | 9.9% | 11.8% |

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 September 30, 2004, cash, cash equivalents and investment securities available for sale totaled \$13,960,000, or 9.6% of total assets, which we believe is adequate to meet short-term liquidity needs.

At September 30, 2004, we had commitments to originate \$40,953,000 of loans. Fixed commitments to incur capital expenditures were less than \$25,000 at September 30, 2004. Certificates of deposit scheduled to mature in the 12-month period ending September 30, 2005 totaled \$50,013,000 at September 30, 2004. 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 September 30, 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.

Southern Community Bank & Trust
Interest Rate Sensitivity GAP Analysis
September 30, 2004
(Dollars in thousands)

| | Within 3 Months | 3 to 6 Months | 7 to 12 Months | 13 to 36 Months | More than 36 Months | Total |
|--|--------------------|------------------|-------------------|--------------------|------------------------------|--------------|
| Interest Rate Sensitive Assets | | | | | | |
| Loans (1) | | | | | | |
| Fixed rate | \$2,179 | \$1,043 | \$ 988 | \$2,133 | \$3,345 | \$9,688 |
| Variable rate | 75,331 | 2,252 | 4,286 | 10,990 | 19,575 | 112,434 |
| Investment securities | 1,805 | - | - | 510 | 3,251 | 5,566 |
| Loans held for sale | 2,985 | - | - | - | - | 2,985 |
| Federal funds sold | 2,599 | - | - | - | - | 2,599 |
| Total rate sensitive assets | 84,899 | 3,295 | 5,274 | 13,633 | 26,171 | 133,272 |
| Cumulative rate sensitive assets | 84,899 | 88,194 | 93,468 | 107,101 | 133,272 | |
| Interest Rate Sensitive Liabilities | | | | | | |
| Interest checking (2) | - | - | - | 5,740 | - | 5,740 |
| Money market accounts | 20,848 | - | - | - | - | 20,848 |
| Savings (2) | - | - | - | 4,365 | - | 4,365 |
| Certificates of deposit | 12,709 | 14,541 | 22,763 | 20,313 | 10,140 | 80,466 |
| FHLB advances | - | - | - | - | 4,000 | 4,000 |
| Other borrowings | 3,599 | - | - | - | - | 3,599 |
| Total rate sensitive liabilities | 37,156 | 14,541 | 22,763 | 30,418 | 14,140 | 119,018 |
| Cumulative rate sensitive liabilities | 37,156 | 51,697 | 74,460 | 104,878 | 119,018 | |
| Rate sensitivity gap for period | \$47,743 | \$(11,246) | \$(17,489) | \$(16,785) | \$12,031 | \$14,254 |
| Cumulative rate | \$47,743 | \$36,497 | \$19,008 | \$2,223 | \$14,254 | |

sensitivity gap

| | | | | | |
|--|--------|--------|--------|--------|--------|
| Ratio of cumulative gap to total assets | 32.8% | 25.1% | 13.1% | 1.5% | 9.8% |
| Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities | 228.5% | 170.6% | 125.5% | 102.1% | 112.0% |
| Ratio of cumulative gap to cumulative rate sensitive assets | 56.2% | 41.4% | 20.3% | 2.1% | 10.7% |

(1) Includes nonaccrual loans of \$418,000, 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 September 30, 2004, our assets that reprice within one year exceeded liabilities that reprice within one year by \$19,008,000 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. The Federal Reserve has increased short-term interest rates by 1% in 2004 and further increases are expected.

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 Bank's Annual Report on Form 10-KSB for the year ended December 31, 2003.

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 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 loans 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 September 30, 2004 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 the 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: November 14, 2004

By: /s/ Thomas W. Winfree

Thomas W. Winfree

President and

Chief Executive Officer

Date: November 14, 2004

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