

UNITED STATES
FEDERAL RESERVE BOARD OF GOVERNORS
Washington, DC 20551

FORM 10-Q

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

For Quarterly Period Ended: September 30, 2005

OR

TRANSITION REPORT UNDER SECTIONS 13 OR 15 (d) OF
THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: _____

MONARCH BANK

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

Virginia

54-1896433

(State or other jurisdiction of
incorporation or organization)

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

750 Volvo Parkway, Chesapeake, Virginia

23320

(Address of principal executive offices)

(Zip Code)

(757) 222-2100

(Issuer's telephone number)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Number of shares of common stock of registrant outstanding at November 8, 2005: 2,862,529

MONARCH BANK
FORM 10-Q
SEPTEMBER 30, 2005

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets
Monarch Bank and Subsidiaries

	Unaudited September 30, 2005	Audited December 31, 2004
ASSETS:		
Cash and cash equivalents:		
Cash and due from banks	\$ 9,192,458	\$ 4,793,560
Interest bearing bank balances	7,367,870	59,840
Federal funds sold	237,850	375,398
Total cash and cash equivalents	16,798,178	5,228,798
Investment securities available-for-sale, at fair value	35,065,620	32,541,028
Investment securities held to maturity, at cost	1,100,000	500,000
Mortgages held for sale	4,989,440	4,157,133
Loans:		
Loans, net of unearned income	236,662,606	178,945,284
Less: allowance for loan losses	(2,414,000)	(1,804,000)
Loans, net	234,248,606	177,141,284
Interest receivable	928,018	637,573
Property and equipment, net	3,374,540	3,159,483
Restricted equity securities	2,013,850	2,350,155
Other assets	1,721,803	1,142,048
Total assets	\$ 300,240,055	\$ 226,857,502
LIABILITIES:		
Deposits:		
Noninterest-bearing	\$ 51,695,726	\$ 29,149,264
Interest-bearing	196,460,649	142,226,933
Total deposits	248,156,375	171,376,197
Borrowings:		
Federal Home Loan Bank advances	20,000,000	30,000,000
Other short-term borrowings	1,990,000	3,812,000
Total borrowings	21,990,000	33,812,000
Other liabilities	1,026,755	552,967
Total liabilities	271,173,130	205,741,164
STOCKHOLDERS' EQUITY:		
Preferred stock, \$5 par value, 2,000,000 shares authorized, none issued	-	-
Common stock, \$5 par value, 5,000,000 shares authorized, issued and outstanding 2,861,829 and 2,400,139 shares, respectively	14,309,145	12,000,695
Additional paid-in capital	12,795,485	8,478,868
Accumulated earnings	2,143,022	784,340
Accumulated other comprehensive loss	(180,727)	(147,565)
Total stockholders' equity	29,066,925	21,116,338
Total liabilities and stockholders' equity	\$ 300,240,055	\$ 226,857,502

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Income Monarch Bank and Subsidiaries

Unaudited

	3 Months Ended September 30,		9 Months Ended September 30,	
	2005	2004	2005	2004
Interest income:				
Interest and fees on loans	\$ 3,892,609	\$ 2,219,504	\$ 10,088,359	\$ 6,139,438
Interest on investment securities				
Taxable	155,813	150,729	454,026	467,938
Nontaxable	-	2,742	1,765	21,051
Interest on federal funds sold	20,871	14,334	33,743	36,026
Dividends on equity securities	21,260	14,469	59,528	41,373
Other interest income	20,323	3,668	25,970	5,405
Total interest income	<u>4,110,876</u>	<u>2,405,446</u>	<u>10,663,391</u>	<u>6,711,231</u>
Interest expense:				
Interest on deposits	1,328,040	746,870	3,229,005	2,172,501
Interest on borrowings	111,530	60,991	387,899	176,277
Total interest expense	<u>1,439,570</u>	<u>807,861</u>	<u>3,616,904</u>	<u>2,348,778</u>
Net interest income	<u>2,671,306</u>	1,597,585	<u>7,046,487</u>	4,362,453
Provision for loan losses	<u>242,771</u>	101,000	<u>642,271</u>	168,000
Net interest income after provision for loan losses	<u>2,428,535</u>	1,496,585	<u>6,404,216</u>	4,194,453
Noninterest income:				
Mortgage banking income	626,765	433,654	1,583,568	1,329,882
Service charges and fees	223,528	196,321	594,276	518,793
Loss on sale of investment securities	-	-	(10,841)	(16,454)
Other	31,867	(5,545)	72,713	(4,956)
Total noninterest income	<u>882,160</u>	<u>624,430</u>	<u>2,239,716</u>	<u>1,827,265</u>
Noninterest expenses:				
Salaries and employee benefits	1,439,618	962,744	3,889,839	2,847,336
Occupancy expenses	152,288	150,130	452,240	395,046
Furniture and equipment expenses	100,033	94,373	285,476	296,509
Data processing services	132,358	155,700	357,784	492,938
Loan origination expenses	139,738	77,476	283,856	190,781
Advertising and marketing expenses	74,504	51,649	170,092	141,573
Professional fees	35,119	35,880	98,311	136,388
Virginia franchise tax	59,567	45,000	149,567	129,000
Stationery and supplies	49,388	22,335	126,977	111,220
Operating losses	21,436	18,947	115,566	24,739
Other	226,124	217,684	656,525	527,735
Total noninterest expenses	<u>2,430,173</u>	<u>1,831,918</u>	<u>6,586,233</u>	<u>5,293,265</u>
Income before income taxes and minority interests	<u>880,522</u>	289,097	<u>2,057,699</u>	728,453
Minority interests in subsidiary's net income	-	-	-	(7,453)
Net income before income taxes	<u>880,522</u>	289,097	<u>2,057,699</u>	721,000
Income tax (expense)	<u>(297,346)</u>	(88,644)	<u>(699,017)</u>	(235,491)
Net income	<u>\$ 583,176</u>	<u>\$ 200,453</u>	<u>\$ 1,358,682</u>	<u>\$ 485,509</u>
Basic net income per share	\$ 0.20	\$ 0.08	\$ 0.52	\$ 0.20
Diluted net income per share	0.20	0.08	0.49	0.20

The accompanying notes are an integral part of these consolidated financial statements.

Item 1. Financial Statements (Continued)

Consolidated Statements of Changes in Shareholders' Equity
Monarch Bank and Subsidiaries

Unaudited

	<u>Common Stock</u>		<u>Additional Paid-In Capital</u>	<u>Accumulated Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>				
Balance - December 31, 2003	2,380,171	\$ 11,900,855	\$ 8,375,708	\$ 27,286	\$ (192,292)	\$ 20,111,557
Net income for nine months ended September 30, 2004	-	-	-	485,509	-	485,509
Unrealized gain on available, for sale securities, net of income taxes	-	-	-	-	73,556	<u>73,556</u>
Total comprehensive income						<u>559,065</u>
Stock options exercised	18,720	93,600	98,900			192,500
Balance - September 30, 2004	<u>2,398,891</u>	<u>\$ 11,994,455</u>	<u>\$ 8,474,608</u>	<u>\$ 512,795</u>	<u>\$ (118,736)</u>	<u>\$ 20,863,122</u>
 Balance - December 31, 2004	 2,400,139	 \$ 12,000,695	 \$ 8,478,868	 \$ 784,340	 \$ (147,565)	 \$ 21,116,338
Net income for nine months ended September 30, 2005	-	-	-	1,358,682	-	1,358,682
Unrealized gain(loss) on available, for sale securities, net of income taxes	-	-	-	-	(33,162)	<u>(33,162)</u>
Total comprehensive income						<u>1,325,520</u>
Stock options exercised	11,690	58,450	61,064			119,514
Proceeds from stock offering, net of issuance costs	450,000	2,250,000	4,255,553			6,505,553
Balance - September 30, 2005	<u>2,861,829</u>	<u>\$ 14,309,145</u>	<u>\$ 12,795,485</u>	<u>\$ 2,143,022</u>	<u>\$ (180,727)</u>	<u>\$ 29,066,925</u>

The accompanying notes are an integral part of these consolidated financial statements.

Item 1. Financial Statements (Continued)

Consolidated Statements of Cash Flows
Monarch Bank and Subsidiaries

Unaudited

	9 Months Ended September 30,	
	2005	2004
Operating activities:		
Net income	\$ 1,358,682	\$ 485,509
Adjustments to reconcile to net cash provided by operating activities:		
Provision for loan losses	642,271	168,000
Provision for depreciation	320,246	308,707
Accretion of discounts and amortization of premiums, net	80,092	141,475
Deferral of loan costs, net of deferred fees	(30,582)	71,072
Net loss on disposition of investment securities	10,841	16,454
Changes in:		
Mortgage loans held for sale	(832,307)	(510,306)
Interest receivable	(290,445)	(7,750)
Other assets	(579,755)	(209,107)
Other liabilities	473,788	316,567
Net cash provided by from operating activities	1,152,831	780,621
Investing activities:		
Purchases of available-for-sale securities	(39,983,319)	(43,533,336)
Purchases of held-to-maturity securities	(600,000)	(500,000)
Sales, maturities, calls and paydowns of available-for-sale securities	37,334,632	50,178,318
Loan originations, net of principal repayments	(57,719,011)	(31,292,140)
Purchases of premises, furniture and equipment	(535,303)	(318,139)
Purchase of restricted equity securities	-	(1,216,395)
Redemption of restricted equity securities	336,305	600,000
Net cash used by investing activities	(61,166,696)	(26,081,692)
Financing activities:		
Net increase in noninterest bearing deposits	22,546,462	12,675,583
Net increase in interest bearing deposits	54,233,716	17,512,819
Net decrease in securities sold under agreements to repurchase	-	(825,660)
Net decrease in federal funds purchased	(1,822,000)	-
Net increase(decrease) in FHLB advances	(10,000,000)	12,000,000
Net decrease in other short-term borrowings	-	(9,790,000)
Proceeds from issuance of common stock, net of issuance costs	6,625,067	192,500
Net cash from financing activities	71,583,245	31,765,242
INCREASE IN CASH AND CASH EQUIVALENTS	11,569,380	6,464,171
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	5,228,798	6,113,441
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 16,798,178	\$ 12,577,612

SUPPLEMENTAL SCHEDULES AND CASH FLOW INFORMATION

Cash paid for:

Interest on deposits and other borrowings	\$ 3,577,151	\$ 2,349,709
Income taxes	\$ 969,335	\$ 40,500

The accompanying notes are an integral part of these consolidated financial statements.

MONARCH BANK
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments consisting of normal recurring accruals necessary to present fairly Monarch Bank's financial position as of September 30, 2005; the consolidated statements of income for the nine and three months ended September 30, 2005 and 2004; the consolidated statements of changes in shareholders' equity for the nine months ended September 30, 2005 and 2004; and the consolidated statements of cash flows for the nine months ended September 30, 2005 and 2004. These financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all of the disclosures and notes required by generally accepted accounting principles. The financial statements include the accounts of Monarch Bank and its subsidiaries, and all significant intercompany accounts and transactions have been eliminated. Operating results for the three and nine month periods ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ended December 31, 2005.

NOTE 2. GENERAL

Monarch Bank ("Monarch" or the "Bank") is a Virginia chartered bank that offers a full range of banking services, primarily to individuals and businesses in the Hampton Roads area of Virginia. Incorporated in Virginia on May 1, 1998, Monarch commenced operations as a commercial bank on April 14, 1999, at its main office in the Greenbrier area in Chesapeake. In addition to its main office, Monarch has six other offices – in the Great Bridge area in Chesapeake, the Lynnhaven area in Virginia Beach, the Town Center area in Virginia Beach, the Oceanfront area in Virginia Beach, the Ghent area in Norfolk, and in downtown Norfolk.

In June 2000, Monarch formed a subsidiary mortgage company, Monarch Home Funding, LLC, ("MHF") to provide permanent residential mortgage loans. MHF began operations as a mortgage broker in September 2000, originating conventional, FHA and VA residential loans. On April 1, 2003, the Bank increased its ownership interest from 51% to 90% in MHF by purchasing interests from its partners. In the third quarter of 2003, MHF became a mortgage lender. As a mortgage lender, MHF can underwrite mortgage loans for its customers, providing additional mortgage related products and services with much more efficiency. MHF originates conventional, FHA and VA residential loans and offers a construction-permanent loan program. On April 1, 2004, Monarch purchased the remaining interest in MHF from its partners, to increase its ownership to 100%. MHF has two offices - one in Chesapeake and one in Norfolk.

In August 2001, the Bank formed Monarch Investments, LLC for the purpose of selling annuities and investment securities and services. The Bank owns a 100% interest in Monarch Investments, LLC. The Bank has invested approximately \$225,000 in the formation of Bankers Investments Group, LLC, the parent company of BI Investments, LLC, a registered brokerage firm and investment advisor. BI Investments, LLC sells non-deposit investment products in various community banks in Virginia, which are partners in Bankers Investments Group, LLC with the Virginia Bankers Association Management Services Division.

In January 2003, the Bank invested approximately \$452,000 for a partial ownership interest in Bankers Insurance, LLC. Owned by 50 community banks, Bankers Insurance is a full service property/casualty and life/health agency that ranks as one of the largest agencies in Virginia. Bankers Insurance provides insurance to Monarch Bank customers and to the general public.

In February 2004, the Bank formed Monarch Capital, LLC for the purpose of engaging in the commercial real estate brokerage business. The Bank owns a 100% interest in Monarch Capital, LLC.

In November 2004, the Bank invested in a partial ownership interest in Bankers Title of Hampton Roads, LLC. Owned by 8 community banks, Bankers Title is a full service title insurance agency. Bankers Title provides title insurance products and services to Monarch Bank and Monarch Home Funding customers and to the general public.

NOTE 3. - EARNINGS PER SHARE (“EPS”)

Basic earnings per share (EPS) excludes dilution, and is computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised, converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations.

	9 months ended September 30,	
	2005	2004
Net income (numerator, basic and diluted)	<u>\$ 1,358,682</u>	<u>\$ 485,509</u>
Weighted average shares outstanding (denominator)	<u>2,606,210</u>	<u>2,395,267</u>
Income per common share - basic	<u>\$ 0.52</u>	<u>\$ 0.20</u>
Weighted average shares - diluted (denominator)	<u>2,707,721</u>	<u>2,455,161</u>
Income per common share - diluted	<u>\$ 0.49</u>	<u>\$ 0.20</u>

	3 months ended September 30,	
	2005	2004
Net income (numerator, basic and diluted)	<u>\$ 583,176</u>	<u>\$ 200,453</u>
Weighted average shares outstanding (denominator)	<u>2,857,186</u>	<u>2,395,734</u>
Income per common share - basic	<u>\$ 0.20</u>	<u>\$ 0.08</u>
Weighted average shares - diluted (denominator)	<u>2,958,341</u>	<u>2,458,704</u>
Income per common share - diluted	<u>\$ 0.20</u>	<u>\$ 0.08</u>

The dilutive effect of stock options is 101,511 and 59,894 shares for the nine months ended September 30, 2005 and 2004, respectively and 101,155 and 62,970 shares for the quarter ending September 30, 2005 and 2004, respectively.

NOTE 4 – COMPREHENSIVE INCOME

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income. The only component of other comprehensive income consists of unrealized gains and losses on available-for-sale securities. The Bank accounts for comprehensive income in accordance with FASB Statement No. 130, Reporting Comprehensive Income. The following is a detail of comprehensive income for the nine and three months ended September 30, 2005 and 2004:

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2005	2004	2005	2004
Net Income	<u>\$ 583,176</u>	<u>\$ 200,453</u>	<u>\$ 1,358,682</u>	<u>\$ 485,509</u>
Change in unrealized gains (losses) on securities available for sale, net of tax expense	<u>(75,982)</u>	<u>191,099</u>	<u>(33,162)</u>	<u>73,556</u>
Total comprehensive income	<u>\$ 507,194</u>	<u>\$ 391,552</u>	<u>\$ 1,325,520</u>	<u>\$ 559,065</u>
Unrealized holding (losses) gains during the period	<u>\$ (115,124)</u>	<u>\$ 289,544</u>	<u>\$ (39,404)</u>	<u>\$ 127,902</u>
Less reclassification adjustment for losses included in income	<u>-</u>	<u>-</u>	<u>10,841</u>	<u>16,454</u>
Total other comprehensive (loss) income before income tax expense	<u>(115,124)</u>	<u>289,544</u>	<u>(50,245)</u>	<u>111,448</u>
Income tax benefit (expense)	<u>39,142</u>	<u>(98,445)</u>	<u>17,083</u>	<u>(37,892)</u>
Net unrealized (losses) gains	<u>\$ (75,982)</u>	<u>\$ 191,099</u>	<u>\$ (33,162)</u>	<u>\$ 73,556</u>

NOTE 5. STOCK BASED COMPENSATION

As of September 30, 2005, the Bank had a stock-based compensation plan. The Bank accounts for the plan under the recognition and measurement principles of APB Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. The following illustrates the effect on net income and earnings per share for the nine month and three month periods ended September 30, 2005, and 2004 had the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, been adopted.

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Net income, as reported	\$ 583,176	\$ 200,453	\$ 1,358,682	\$ 485,509
Deduct: total stock-based employee compensation expense based on fair value method of awards	<u>(30,113)</u>	<u>(4,970)</u>	<u>(51,162)</u>	<u>(20,618)</u>
Pro forma net income	<u>\$ 553,063</u>	<u>\$ 195,483</u>	<u>\$ 1,307,520</u>	<u>\$ 464,891</u>
Basic earnings per share:				
As reported	\$ 0.20	\$ 0.08	\$ 0.52	\$ 0.20
Pro forma	\$ 0.20	\$ 0.08	\$ 0.50	\$ 0.19
Diluted earnings per share:				
As reported	\$ 0.20	\$ 0.08	\$ 0.49	\$ 0.20
Pro forma	\$ 0.19	\$ 0.08	\$ 0.48	\$ 0.19

NOTE 6. SEGMENT REPORTING

Reportable segments include community banking and mortgage banking services. Community banking involves making loans to and generating deposits from individuals and businesses in the markets where the Bank has offices. Mortgage banking originates residential loans and subsequently sells them to investors. The mortgage banking segment is a strategic business unit that offers different products and services. It is managed separately because the segment appeals to different markets and, accordingly, requires different technology and marketing strategies. The segment's most significant revenue and expense is noninterest income and noninterest expense, respectively. The Bank does not have other reportable operating segments. The accounting policies of the segment are the same as those described in the summary of significant accounting policies. All intersegment sales prices are market based. The assets and liabilities and operating results of the Bank's other wholly owned subsidiary, Monarch Capital, LLC is included in the mortgage banking segment. Monarch Capital, LLC provides commercial mortgage brokerage services.

Segment information for the three and nine months ended September 30, 2005 and 2004 is shown in the following table. The “Other” category includes corporate related items, results of insignificant operations and, as it relates to segment profit (loss), income and expense not allocated to reportable segments.

	<u>Community Banking</u>	<u>Mortgage Banking</u>	<u>Intersegment Eliminations</u>	<u>Total</u>
Three Months Ended September 30, 2005				
Net interest income after provision for loan losses	\$ 2,490,094	\$ (61,559)	\$ -	\$ 2,428,535
Noninterest income	333,724	626,765	(78,329)	882,160
Noninterest expense	<u>(1,943,297)</u>	<u>(500,376)</u>	<u>13,500</u>	<u>(2,430,173)</u>
Net income before income taxes and minority interests	<u>\$ 880,521</u>	<u>\$ 64,830</u>	<u>\$ (64,829)</u>	<u>\$ 880,522</u>
Three Months Ended September 30, 2004				
Net interest income after provision for loan losses	\$ 1,530,648	\$ (34,063)	\$ -	\$ 1,496,585
Noninterest income	267,219	433,654	(76,443)	624,430
Noninterest expense	<u>(1,516,098)</u>	<u>(321,820)</u>	<u>6,000</u>	<u>(1,831,918)</u>
Net income before income taxes and minority interests	<u>\$ 281,769</u>	<u>\$ 77,771</u>	<u>\$ (70,443)</u>	<u>\$ 289,097</u>
Nine Months Ended September 30, 2005				
Net interest income after provision for loan losses	\$ 6,522,076	\$ (117,860)	\$ -	\$ 6,404,216
Noninterest income	890,442	1,583,568	(234,294)	2,239,716
Noninterest expense	<u>(5,354,819)</u>	<u>(1,272,914)</u>	<u>41,500</u>	<u>(6,586,233)</u>
Net income before income taxes and minority interests	<u>\$ 2,057,699</u>	<u>\$ 192,794</u>	<u>\$ (192,794)</u>	<u>\$ 2,057,699</u>
Nine Months Ended September 30, 2004				
Net interest income after provision for loan losses	\$ 4,260,644	\$ (66,191)	\$ -	\$ 4,194,453
Noninterest income	761,375	1,329,882	(263,992)	1,827,265
Noninterest expense	<u>(4,308,347)</u>	<u>(999,918)</u>	<u>15,000</u>	<u>(5,293,265)</u>
Net income before income taxes and minority interests	<u>\$ 713,672</u>	<u>\$ 263,773</u>	<u>\$ (248,992)</u>	<u>\$ 728,453</u>
Segment Assets				
2005	\$ 300,575,499	\$ 5,907,860	\$ (6,243,304)	\$ 300,240,055
2004	\$ 217,129,796	\$ 2,797,169	\$ (3,250,323)	\$ 216,676,642

CRITICAL ACCOUNTING POLICIES

The Bank's critical accounting policies are listed below. A summary of the Bank's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements in the Bank's 2004 Annual Report on Form 10-KSB.

The Bank's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within our statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

The financial statements and related data presented herein were prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars, without considering the changes in relative purchasing power of money over time due to inflation. The effect of changing prices on financial institutions is typically different from other industries as the Bank's assets and liabilities are monetary in nature. Interest rates are significantly impacted by inflation, but neither the timing nor the magnitude of the changes are directly related to price level indices.

On March 9, 2004, the SEC Staff issued Staff Accounting Bulletin No. 105, "*Application of Accounting Principles to Loan Commitments*" ("SAB 105"). SAB 105 clarifies existing accounting practices relating to the valuation of issued loan commitments, including interest rate lock commitments ("IRLC"), subject to SFAS No. 149 and Derivative Implementation Group Issue C13, "*Scope Exceptions: When a Loan Commitment is included in the Scope of Statement 133.*" Furthermore, SAB 105 disallows the inclusion of the values of a servicing component and other internally developed intangible assets in the initial and subsequent IRLC valuation. The provisions of SAB 105 were effective for loan commitments entered into after March 31, 2004. The Company has adopted the provisions of SAB 105. Since the provisions of SAB 105 affect only the timing of the recognition of mortgage banking income, management does not anticipate that this guidance will have a material adverse effect on either the Company's consolidated financial position or consolidated results of operations.

Emerging Issues Task Force Issue No. (EITF) 03-1 "*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*" was issued and is effective March 31, 2004. The EITF 03-1 provides guidance for determining the meaning of "other than-temporarily impaired" and its application to certain debt and equity securities within the scope of Statement of Financial Accounting Standards No. 115 "*Accounting for Certain Investments in Debt and Equity Securities*" ("SFAS No. 115") and investments accounted for under the cost method. The guidance requires that investments which have declined in value due to credit concerns or solely due to changes in interest rates must be recorded as other-than-temporarily impaired unless the Company can assert and demonstrate its intention to hold the security for a period of time sufficient to allow for a recovery of fair value up to or beyond the cost of the investment which might mean maturity. This issue also requires disclosures assessing the ability and intent to hold investments in instances in which an investor determines that an investment with a fair value less than cost is not other-than-temporarily impaired.

On September 30, 2004, the Financial Accounting Standards Board decided to delay the effective date for the measurement and recognition guidance contained in Issue 03-1. This delay does not suspend the requirement to recognize other-than-temporary impairments as required by existing authoritative literature. The disclosure guidance in Issue 03-1 was not delayed. Management continues to study this new issue but does not anticipate that this guidance will have a material adverse effect on either the Company's consolidated financial position or consolidated results of operations.

EITF No. 03-16, "*Accounting for Investments in Limited Liability Companies*" was ratified by the Board and is effective for reporting periods beginning after June 15, 2004. APB Opinion No. 18, "*The Equity Method of Accounting Investments in Common Stock*," prescribes the accounting for investments in common stock of corporations that are not consolidated. AICPA Accounting Interpretation 2, "*Investments in Partnerships Ventures*," of Opinion 18, indicates that "many of the provisions of the Opinion would be appropriate in accounting" for partnerships. In *EITF Abstracts*, Topic No. D-46, "*Accounting for Limited Partnership Investments*," the SEC staff clarified its view that investments of more than 3 to 5 percent are considered to be more than minor and, therefore, should be accounted for using the equity method. Limited liability companies (LLCs) have characteristics of both corporations and partnerships, but are dissimilar from both in certain

respects. Due to those similarities and differences, diversity in practice exists with respect to accounting for non-controlling investments in LLCs. The consensus reached was that an LLC should be viewed as similar to a corporation or similar to a partnership for purposes of determining whether a non-controlling investment should be accounted for using the cost method or the equity method of accounting.

On July 30, 2002, Congress enacted the Sarbanes-Oxley Act of 2002 (the Act). Among other provisions, the Act provides for the establishment of the Public Company Accounting Oversight Board, rules with respect to auditor independence, corporate governance and responsibility, and enhanced financial disclosures. One of the more significant provisions of Section 404 of Sarbanes-Oxley involves internal control attestation by independent auditors. This provision was to first apply to the Company as of December 31, 2005. However, on March 2, 2005, the Securities and Exchange Commission extended the dates for non-accelerated filers to comply with Section 404 of the Act. As the Company is a non-accelerated filer, its compliance date was extended to December 31, 2007

ITEM 2.

MONARCH BANK
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS

The purpose of this discussion is to focus on important factors affecting the Bank's financial condition and results of operations. The discussion and analysis should be read in conjunction with the Consolidated Financial Statements, and supplemental financial data.

This report contains forward-looking statements with respect to the financial condition, results of operations and business of the Bank. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Bank and on information available at the time these statements and disclosures were prepared. Factors that may cause actual results to differ materially from those expected include the following:

- General economic conditions may deteriorate and negatively impact the ability of borrowers to repay loans and depositors to maintain balances.
- Changes in interest rates could reduce income.
- Competitive pressures among financial institutions may increase.
- The businesses that the Bank is engaged in may be adversely affected by legislative or regulatory changes, including changes in accounting standards.
- New products developed or new methods of delivering products could result in a reduction in business and income for the Bank.
- Adverse changes may occur in the securities market.

Earnings Summary

Monarch Bank reported net income of \$1,358,682 for the nine-month period ending September 30, 2005, compared to \$485,509 for the same period in 2004, an increase of \$873,173, or 179.8%. Net interest income, the Bank's primary source of earnings, increased \$2,684,034, or 61.5%, for the first nine months of 2005, compared to 2004. Noninterest income increased \$412,451 or 22.6% and noninterest expenses increased \$1,292,968, or 24.4%. Basic and diluted earnings per share of common stock were \$0.52 and \$0.49 for the first nine months of 2005 compared to \$0.20 and \$0.20 in 2004.

Monarch Bank reported net income of \$583,176 for the three-month period ending September 30, 2005, compared to \$200,453 for the same period in 2004, an increase of \$382,723, or 190.9%. Net interest income increased \$1,073,721, or 67.2%, during the 2005 third quarter, compared to 2004. Noninterest income increased \$257,730 or 41.3% and noninterest expenses increased \$598,255, or 32.7%. Basic and diluted earnings per share of common stock were \$0.20 and \$0.20 for the third quarter of 2005 and \$0.08 and \$0.08 for 2004. The third quarter of 2005 was Monarch Bank's twenty-first consecutive profitable quarter.

For the nine months ended September 30, 2005, profitability as measured by Monarch's annualized return on average assets (ROA) was 0.75% compared to 0.35% for the same period in 2004, an increase of 114%. ROA for the third quarter ended September 30, 2005 was 0.87% compared to 0.40% in 2004. Another measure of the Bank's profitability, the annualized return on average equity (ROE) increased to 7.20% for the first nine months of 2005 compared to 3.18% for 2004. Results for ROE were 7.88% for the quarter ending September 30, 2005 compared to 3.85% for the same period in 2004.

Net Interest Income

Net interest income represents a principal source of earnings for the Bank. Increases in net interest income are primarily attributable to the overall growth of the Bank, arising from higher average outstanding balances in 2005 than 2004 and the increase in the net interest margin. The Federal Reserve Bank's Open Market Committee began increasing short-term interest rates in late June of 2004, and increased rates twice during the first quarter of 2005, twice during the second quarter of 2005, and an additional two times during the third quarter of 2005. These increases raised the Federal Funds rate from 2.25% to 3.75% by the end of the first nine months of 2005. The increase in the Federal funds target rate raised the Wall Street Journal Prime Rate from 5.25% to 6.75% during 2005. A majority of the Bank's loans use the Wall Street Journal Prime Rate as their rate index, and increases in this rate increase interest income.

Net interest income was \$7,046,487 for the first nine months of 2005, compared to \$4,362,453 for the same period in 2004, an increase of \$2,684,034 or 61.5%. Total interest and fees on loans increased by \$3,948,921, or 64.3% for the nine months ended September 30, 2005 compared to 2004. Interest on investment securities decreased \$33,198 or 6.8%. With the rate increases in early 2005 and late 2004, a management decision was made to reduce the fixed rate securities portfolio in favor of variable rate loans due to the higher yields and faster repricing available on loans. Interest on federal funds sold decreased \$2,283 or 6.3% due to lower volume and management's decision to utilize higher interest rates offered on interest bearing bank accounts. This is reflected in a \$20,565, or 380.5% increase in other interest income. Dividends on restricted equity securities increased \$18,155 or 43.9% for the first nine months of 2005 compared to 2004 as a result of increases in yields and higher balances of stock in the Federal Reserve and the Federal Home Loan Bank of Atlanta.

Net interest income for the third quarter ended, September 30, 2005 increased \$1,073,721 or 67.2% over the same period in 2004. Interest and fees on loans increased \$1,673,105 or 75.4%, while interest on investment securities was relatively flat. Interest on federal funds sold increased 45.6% of \$6,537. Other interest income increased \$16,655 or 454.1%. Dividends on restricted equity securities increased 46.9% or \$6,791 when compared to third quarter 2004.

Interest expense on deposits increased \$1,056,504, or 48.6% and interest expense on borrowings increased \$211,622 or 120.1% for the first nine months of 2005 compared to 2004. Interest expense on deposits increased \$581,170 or 77.8% for the third quarter of 2005 compared to the same period in 2004. The increase in deposit expense is due to the increase in average deposits, arising from the overall growth of the Bank and an increase in the overall rates paid on deposits. Interest expense on borrowings increased \$50,539 or 82.9% for the third quarter of 2005 compared to the same period in 2004. This increase is the result of a higher rate environment and the Bank's strategy to replace higher cost out-of-market certificates of deposits with FHLB borrowings.

Average Balances, Income and Expenses, Yields and Rates

The net interest spread on a tax-equivalent basis improved for first nine months of 2005 to 3.40% compared to 2.79% for the same period in 2004. The yield on earning assets increased 107 basis points to 6.15%, while the rate on interest bearing liabilities increased only 46 basis points to 2.75%. This resulted in the improved interest rate spread and net interest margin. The net interest margin was at its highest level since 2001.

The following table sets forth average balances of total interest earning assets and total interest bearing liabilities for the periods indicated, showing the average distribution of assets, liabilities, stockholders' equity and the related income, expense and corresponding weighted average yields and costs.

AVERAGE BALANCES, INCOME AND EXPENSE, YIELDS AND RATES

	For Periods Ended September 30,					
	2005			2004		
	Average Balance	Income/ Expense	Yield Rate(1)	Average Balance	Income/ Expense	Yield Rate(1)
ASSETS						
Securities, at amortized cost						
Taxable	\$ 17,940,142	\$ 454,026	3.38%	\$ 20,683,174	\$ 467,938	3.02%
Tax-exempt (2)	138,108	2,674	2.59%	1,299,074	28,208	2.90%
Total securities	18,078,250	456,700	3.38%	21,982,248	496,146	3.01%
Loans, net	209,446,821	10,088,359	6.44%	148,462,497	6,139,438	5.52%
Federal funds sold	1,484,431	33,743	3.04%	4,480,195	36,026	1.07%
Dividend-earning restricted equity securities	1,790,627	59,528	4.44%	1,198,850	41,373	4.61%
Interest-bearing deposits at other banks	1,072,698	25,970	3.24%	614,443	5,405	1.18%
Total earning assets	231,872,827	10,664,300	6.15%	176,738,233	6,718,388	5.08%
Less: Allowance for loan losses	(2,061,514)			(1,559,973)		
Total nonearning assets	12,247,628			12,615,091		
Total assets	<u>\$ 242,058,941</u>			<u>\$ 187,793,351</u>		
LIABILITIES and STOCKHOLDERS' EQUITY						
Interest-bearing deposits:						
Checking	\$ 9,852,557	\$ 18,851	0.26%	\$ 8,809,877	\$ 23,135	0.35%
Regular savings	14,330,712	73,041	0.68%	18,030,002	92,447	0.68%
Money market savings	55,580,326	1,162,808	2.80%	12,080,622	108,865	1.20%
Certificates of deposit						
\$100,000 and over	34,284,661	862,634	3.36%	47,797,357	1,138,877	3.18%
Under \$100,000	44,193,850	1,111,671	3.36%	38,944,497	809,177	2.78%
Total interest-bearing deposits	158,242,106	3,229,005	2.73%	125,662,355	2,172,501	2.31%
Borrowings	17,553,931	387,899	2.95%	11,608,493	176,277	2.03%
Total interest-bearing liabilities	175,796,037	\$ 3,616,904	2.75%	137,270,848	\$ 2,348,778	2.29%
Noninterest-bearing liabilities						
Demand deposits	40,268,418			29,869,492		
Other noninterest-bearing liabilities	794,715			196,726		
Total liabilities	216,859,170			167,337,066		
Shareholders' equity	25,199,771			20,456,285		
Total liabilities and stockholders' equity	<u>\$ 242,058,941</u>			<u>\$ 187,793,351</u>		
Net interest income (2)		<u>\$ 7,047,396</u>			<u>\$ 4,369,610</u>	
Interest rate spread (2)(3)			<u>3.40%</u>			<u>2.79%</u>
Net interest margin (2)(4)			<u>4.06%</u>			<u>3.30%</u>

(1) Yields are annualized and based on average daily balances.

(2) Income and yields are reported on a taxable equivalent basis assuming a federal tax rate of 34%, with a \$909 adjustment for 2005 and a \$7,157 adjustment for 2004.

(3) Represents the differences between the yield on total average earning assets and the cost of total interest-bearing liabilities.

(4) Represents the ratio of net interest-earnings to the average balance of interest-earning assets.

Noninterest Income

During the nine month period ending September 30, 2005, total noninterest income, including security gains and losses, increased by \$412,451 or 22.6% to \$2,239,716 from \$1,827,265 for the same period in 2004. During the quarter ended September 30, 2005, total noninterest income, including security gains and losses, increased by \$257,730 or 41.3% to \$882,160 from \$624,430 for the same period in 2004.

Gross mortgage banking income from the Bank's mortgage subsidiary, Monarch Home Funding, LLC makes up the largest component of this increase for both the first nine months of 2005 and the third quarter of 2005. Respective increases were \$253,686 or 19.1%, and \$193,111 or 44.5%. The number of loans closed for the first nine months of 2004 is 8% higher and the dollar volume is 40.6% higher than the same period in 2004. Increases in mortgage interest rates during 2005 and a more competitive environment that required more competitive pricing have also had an impact on income. The new and existing home sale market continues to perform well in the Bank's primary trade area, with some softening noted late in the third quarter.

Service charges and fees on deposit accounts increased \$27,207 for the three month period ending September 30, 2005, or 13.9%, from the same period in 2004. The primary components in this increase were deposit account growth and ATM transaction fees. The Bank has an agreement with a third-party vendor to brand ATMs in Food Lion grocery stores in southeast Virginia and northeast North Carolina. This relationship plus the Bank's 7 office ATMs, creates a network that now includes 42 active ATMs. In return for supplying the cash for the machines and paying the machines' cash servicing fees, the Bank receives a portion of the transaction surcharge and the Bank's customers can withdraw cash from the machines without a fee or transaction surcharge. A portion of the ATM fee increase was also due to fees generated at the Bank's 7 ATMs located at the banking center sites.

Net losses on the sales of investment securities amounted to \$10,841 for the first nine months of 2005, compared to a \$16,454 net loss in 2004. No gains or losses were recognized in the third quarter of 2005 or 2004. Management took losses in certain security positions to improve future investment portfolio yield.

Noninterest Expense

Total noninterest expenses for the third quarter of 2005 were \$2,430,173, an increase of \$598,255, or 32.7%, compared to \$1,831,918 for the same period last year. This increase is attributable to following factors: 1) an increase in salaries and employee benefits of \$476,874, primarily arising from additional salaries due to two new banking offices, additional mortgage lenders, the addition of new production and support staff, and higher employee benefit costs; and 2) an increase of \$121,381 in other expenses related to the Bank's growth. Savings were observed in data processing services due to the Bank hiring an internal technology position to replace higher cost outsourced services.

During the nine month period ending September 30, 2005, total noninterest expenses were \$6,586,233, an increase of \$1,292,968, or 24.4% over the same period last year. Increases for the nine month period were similar to the items listed above for the third quarter.

Income Taxes

The income tax provision for the first nine months of 2005 was \$699,017, an increase of \$463,526 from \$235,491 reported a year earlier. The effective tax rate for the third quarter of 2005 was 33.8% and 34.0% for the first nine month period of 2005, compared to 31.0% and 34.0% for the same periods in 2004.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

GENERAL

Total assets increased 32.3% to \$300,240,055 at September 30, 2005 when compared to assets of \$226,857,502 at December 31, 2004. On an annual basis total assets increased 38.6% at September 30, 2005 when compared to assets of \$216,676,642 at September 30, 2004. Total loans as of September 30, 2005 were \$236.7 million, an increase of \$57.7 million, or 32.2%, from \$178.9 million at year-end 2004. On an annual basis total loans increased \$71.3 million, or 43.1%, from \$165.3 million in September 2004. Mortgages held for sale increased \$832 thousand to \$4.9 million, a 20.2% increase from \$4.1 million at December 31, 2004. Investment securities increased 9.5% to \$36.2 million at September 30, 2005 compared to year-end 2004. Cash and cash equivalents were \$16.8 million, an increase of \$11.6 million, or 221.2% from \$5.2 million at December 31, 2004.

Deposits increased \$76.8 million, or 44.8%, during the nine months ended September 30, 2005. Noninterest-bearing demand deposit accounts increased \$22.5 million to \$51.7 million, a 77.3% increase over December 31, 2004. Interest bearing deposits totaled \$196.4 million at September 30, 2005, compared to \$142.2 million at year-end 2004. Money market deposits continue to be a major contributor to this growth due to attractive product pricing.

Stockholders' equity was \$29.1 million at September 30, 2005, compared to \$21.1 million at December 31, 2004. Components of the change in stockholders' equity include net income of \$1,358,682, increases in net unrealized losses on available-for-sale securities totaling \$33,162, exercised stock options totaling \$119,514, and net proceeds from a public stock offering that totaled \$6,505,553.

Asset Quality

The Bank had one nonperforming asset at September 30, 2005 totaling \$528 which was paid off in early October. There were no nonperforming assets at December 31, 2004. Nonperforming assets traditionally consist of nonaccrual loans, loans past due 90 days or more and still accruing interest, restructured loans and other real estate owned. There were no impaired loans at September 30, 2005 and December 31, 2004. The Bank continues to demand a high level of credit quality on new loans.

Allowance for Loan Losses

The allowance for loan losses is to provide for losses inherent in the loan portfolio. The Bank's Loan Committee has responsibility for determining the level of the allowance for loan losses, subject to the review of the Board of Directors. Among other factors, the Committee on a quarterly basis considers the Bank's historical loss experience, the size and composition of the loan portfolio, the value and adequacy of collateral and guarantors, nonperforming credits, the Bank's loan "Watch" list, and national and local economic conditions.

While the Bank believes it has sufficient allowance for its existing portfolio, there can be no assurances that an additional allowance for losses on existing loans may not be necessary in the future. The allowance for loan losses totaled \$2,414,000 and \$1,668,000 at September 30, 2005 and 2004, respectively. The ratio of the allowance for loan losses to total loans outstanding at September 30, 2005 and 2004 was 1.02% and 1.01%, respectively.

During the first nine months of 2005 and 2004, the Bank recorded \$642,271 and \$168,000 in provision expense, respectively. There was one charge off in the first nine months of 2005 totaling \$32,271 and no loans charged off in 2004. Charge offs are charged directly to the allowance when they occur. Since it began business in 1999, the Bank has had the current business charge off and two small consumer charge offs which totaled less than \$2,000. Recoveries during the first quarters of 2005 and 2004 amounted to \$0. The table below summarizes the activity in the allowance for loans losses for the nine month periods ending September 30, 2005 and 2004.

Activity in the allowance for loan losses for the nine months ended September 30 was as follows:

	<u>2005</u>	<u>2004</u>
Balance, January 1	\$ 1,804,000	\$ 1,500,000
Provisions charged against income	642,271	168,000
Recoveries of loans charged off	0	0
Loans charged off	<u>(32,271)</u>	<u>0</u>
Balance at end of period	<u>\$ 2,414,000</u>	<u>\$ 1,668,000</u>

The Bank has developed a methodology to determine an allowance to absorb probable loan losses inherent in the portfolio based on evaluations of the potential collection of loans, historical loss experience, peer bank loss experience, delinquency trends, economic conditions, portfolio composition, and specific loss estimates for loans considered substandard or doubtful. All commercial and commercial real estate loans that exhibit probable or observed credit weaknesses are subject to individual review. If necessary, reserves would be allocated to individual loans based on management's estimate of the borrower's ability to repay the loan given the availability of collateral and other sources of cash flow. Any reserves for impaired loans are measured based on the present rate or fair value of the underlying collateral. The Bank evaluates the potential collection of both principal and interest when assessing the need for a loss accrual. A composite allowance factor that considers the Bank's and other peer bank loss experience ratios, delinquency trends, economic conditions, and portfolio composition are applied to the total of commercial and commercial real estate loans not specifically evaluated.

Homogenous loans, such as consumer installment, residential mortgage loans, home equity loans, and smaller consumer loans are not individually reviewed and are generally risk graded at the same levels. The risk grade and reserves are established for each homogenous pool of loans are based on the expected net charge offs from a current trend in delinquencies, losses or historical experience and general economic conditions. The Bank has no material delinquencies in these types of loans, and has not, since inception, had a trend or an indication of a trend that would guide the Bank in expected material losses in these types of homogenous pools of loans. Management believes that the allowance for loan losses is adequate to absorb any inherent losses on existing loans in the Bank's loan portfolio at September 30, 2005.

Liquidity

Management monitors and plans the Bank's liquidity position for future periods. Liquidity is provided from cash and due from banks, interest-bearing deposits in other banks, repayments from loans, increases in deposits, lines of credit from four correspondent banks and two federal agency banks and a planned structured continuous maturity of investments. Management believes that these factors provide sufficient and timely liquidity for the foreseeable future.

Management also takes into account any liquidity needs generated by off-balance sheet transactions such as commitments to extend credit, commitments to purchase securities and standby letters of credit.

The Bank has a line of credit that can equal to up to 40% of assets with the Federal Home Loan Bank of Atlanta (FHLB) that equaled approximately \$84,760,000 with \$64,760,000 available at September 30, 2005. This line is currently reduced by \$3.0 million, which has been pledged as collateral for public deposits. Should the Bank ever desire to increase their line of credit beyond the current 40% limit, the FHLB would allow borrowings of up to 50% of total assets once the bank meets specific eligibility requirements.

Borrowings outstanding under the FHLB line of credit were \$20,000,000 at September 30, 2005 and \$30,000,000 at December 31, 2004. The Bank has three borrowing advances outstanding as of September 30, 2005, with the following final maturities:

<u>Advance Amount</u>	<u>Expiration Date</u>
\$ 8,000,000	October 2005
5,000,000	March 2012
5,000,000	February 2013
<u>2,000,000</u>	September 2015
<u>\$20,000,000</u>	

The advance maturing in 2013 is a convertible advance that matures on February 27, 2013, but has a one-time call provision on February 27, 2008. At that date, the FHLB can call the borrowing; if it does, the Bank has the option of repaying the advance or refinancing at the then current rate. The interest rate is currently 2.97%.

The advance maturing in 2012 has a one time repayment option in 2007, whereby the Bank can repay the borrowing. If not paid at that time the borrowing converts to a fixed-term five year borrowing at the then current rates. This borrowing floats at a rate set below 90 day Libor rates until reset date. The interest rate is currently 3.33%.

The advance maturing in 2015 is a principal reducing credit that matures on September 28, 2015. Terms include 39 quarterly principal payments of \$25k beginning December 2005, with a final payment of \$1,025,500 in September 2015. The bank is utilizing this advance to match-fund several long term fixed rate loans. The interest rate for this advance is fixed at 4.96%.

In the course of operations, due to fluctuations in loan and deposit levels, the Bank occasionally finds it necessary to purchase Federal Funds on a short-term basis. The Bank also has federal funds lines of credit facilities established with four other banks in the total amount of \$17,000,000 available. At September 30, 2005 there was \$1,990,000 outstanding on these lines. The Bank also has access to the Federal Reserve Bank's discount window should a liquidity crisis occur.

The Bank has no material commitments or long-term debt for capital expenditures at the report date. The only long-term debt is for funding loans and is described below under Borrowings.

The Bank uses borrowings at the end of each quarter to increase its investment securities that are not subject to taxation by the Commonwealth of Virginia. The Bank is not subject to state income tax but is subject to Virginia Franchise Tax, which is calculated on its capital level, less certain deductions. One deduction is the average balances of bonds that are not subject to taxation by the Commonwealth of Virginia, primarily certain qualified U.S. Government Agency bonds. The Bank has found that it can save more in taxes than it pays in interest expense. Right before the end of each calendar quarter, the Bank purchases FHLB discount notes that mature soon after the quarter-end. The proceeds from the maturity of the discount note are used to repay the borrowings. The Bank only enters into this type of agreement near the end of the quarter since that is the period used in the franchise tax calculation.

Off-Balance Sheet Arrangements

The Bank enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance sheet transactions. The off-balance sheet transactions recognized as of September 30, 2005 and December 31, 2004 were commitments to extend credit and standby letters of credit issued to customers and a line of credit from Federal Home Loan Bank for \$3 million to secure public deposits.

Commitments to extend credit, which amounted to \$79,934,000 at September 30, 2005, and \$81,746,000 at December 31, 2004, represent legally binding agreements to lend to customers with fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future liquidity requirements.

As of September 30, 2005 the Bank has a commitment to purchase a \$500k Federal Home Loan Bank security, scheduled to settle November 3, 2005. On December 31, 2004, there were no commitments to purchase securities.

Standby letters of credit are conditional commitments issued by the Bank guaranteeing the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. At September 30, 2005 and December 31, 2004, the Bank had \$696,797 and \$1,058,000 respectively, in outstanding standby letters of credit.

The Bank and its subsidiary, Monarch Home Funding, LLC, have eight non-cancelable leases for premises. The original lease terms are from 90 days to thirty years and have various renewal and option dates.

Capital Adequacy

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy

guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Management reviews the adequacy of the Bank's capital on an ongoing basis with reference to the size, composition, and quality of the Bank's resources and compliance with regulatory requirements and industry standards. Management seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and absorb potential losses.

Federal regulatory risk-based capital ratio guidelines require percentages to be applied to various assets including off-balance-sheet assets in relation to their perceived risk. Tier 1 capital consists of stockholders' equity and minority interests in consolidated subsidiaries, less net unrealized gains on available-for-sale securities. Tier 2 capital, a component of total capital, consists of a portion of the allowance for loan losses, certain components of nonpermanent preferred stock and subordinated debt. Monarch's ratios exceed regulatory requirements. As of September 30, 2005 the Corporation had a Tier 1 risk-based capital ratio of 10.94% and a Total risk-based capital ratio of 11.54%. At December 31, 2004 these ratios were 9.92% and 10.76%, respectively.

On April 11, 2005, the Bank announced a public offering of a minimum of 250,000 shares and a maximum of 450,000 shares of common stock at a pre-established price of \$14.50 per share. The offering ran until May 31, 2005 with the full 450,000 shares sold. The number of shares issued and outstanding increased to 2,857,029 from 2,407,029 with the completion of this offering. This capital is being used for general corporate purposes to support the continued growth of the Bank.

On May 6, 2004, the Board of Directors approved a 6-for-5 stock split to stockholders of record on May 17, 2004. The number of shares issued and outstanding, both prior to and subsequent to the stock split, were approximately 1,987,676 and 2,385,211, respectively. The Bank's stock par value was affected by the stock split; additional paid in capital was adjusted so that the stock par value remains at \$5.00 per share. All share and per share amounts are retroactively adjusted to reflect the stock split.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The effective management of market risk is essential to achieving the Bank's objectives. Market risk reflects the risk of economic loss resulting from adverse changes in market prices and interest rates. This risk of loss can be reflected in diminished current market values and/or reduced potential net interest income in future periods. The Corporation is not subject to currency exchange risk or commodity price risk.

As a financial institution, interest rate risk and its impact on net interest income is the primary market risk exposure. The Asset/Liability Management Committee ("ALCO") is primarily responsible for establishing asset and liability strategies and for monitoring and controlling liquidity and interest rate risk. The Bank evaluates interest sensitivity risk in accordance with its asset liability policies, and then formulates strategies regarding asset originations, pricing, funding sources, and off-balance sheet commitments in order to decrease sensitivity risk. These strategies are based on management's outlook regarding future interest rate movements, the state of the regional and national economy, and other financial and business risk factors. The Bank establishes prices for deposits and loans based primarily on local market conditions.

The interest sensitivity position ("gap") is the difference between interest sensitive assets and interest sensitive liabilities in a specific time interval. The gap can be managed by repricing assets or liabilities, affected by selling securities available for sale, by replacing an asset or liability at maturity, or by adjusting the interest rate or the life of an asset or liability. Matching of assets and liabilities repricing in the same interval helps to hedge the risk and minimize the impact on interest income in periods of rising and falling interest rates.

Generally, positive gaps affect net interest margins and earnings negatively in periods of falling rates, and conversely, higher negative gaps adversely impact net interest margin and earnings in periods of rising rates as a higher volume of liabilities will reprice quicker than assets over the period for which the gap is computed.

Impacts of changing interest rates on loans and deposits are reflected in the Bank's financial statements. Management believes that the mortgage banking operations of its subsidiary, Monarch Home Funding, LLC, provide somewhat of a natural interest rate hedge, in that the Bank is interest rate sensitive in the three-month period. When loan

interest rates decline, the Company's earnings will be negatively impacted in the three-month period but the mortgage company's volume should increase as the demand for refinancing increases. The reverse should occur in rising interest rate.

Monarch is asset-sensitive, primarily due to its adjustable rate loan portfolio. The majority of these loans are indexed to the Wall Street Journal Prime rate and can adjust either daily or monthly. This asset-sensitive position positively impacts the Bank in a rising rate environment, as asset-yields rise faster than the cost of funding those assets.

ITEM 4. CONTROLS AND PROCEDURES

We maintain a system of internal controls and procedures designed to provide reasonable assurance as to the reliability of our published financial statements and other disclosures included in this report. Within the 90 days prior to the date of this report, the Corporation carried out an evaluation, under the supervision and with the participation of the Bank's management, including the Bank's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Bank's Chief Executive Officer and Chief Financial Officer concluded that the Bank's disclosure controls and procedures are effective in timely alerting them to material information relating to the Corporation (including its consolidated subsidiaries) required to be included in periodic SEC filings. There have been no significant changes in the Bank's internal controls or in other factors that could significantly affect internal controls subsequent to the date the Corporation carries out its evaluation.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

In the course of its operations, Monarch Bank and its subsidiary are not aware of any material pending or threatened litigation, unasserted claims and/or assessments through September 30, 2005 or subsequent thereto.

Item 2. Changes in Securities

None.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submissions of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K.

a. Exhibits

Exhibit 11 – Refer to EPS calculation in the Notes to Financial Statements

Exhibit 31.1 – Certification of CEO pursuant to Rule 13a-14(a)

Exhibit 31.2 – Certification of Principal Financial Officer pursuant to Rule 13a-14(a)

Exhibit 32.1 – Certification of CEO pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 – Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

b. Form 8-K.

Form 8-K filed July 25, 2005 to announce the Bank's quarterly financial performance

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MONARCH BANK

William F. Rountree, Jr.
President & Chief Executive Officer

Date: November 8, 2005

Brad E. Schwartz
Executive Vice President & Chief Financial Officer

Date: November 8, 2005

SECTION 302 CERTIFICATION

I, William F. Rountree, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Monarch Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2005

William F. Rountree, Jr.,
Chief Executive Officer

SECTION 302 CERTIFICATION

I, Brad E. Schwartz, certify that:

2. I have reviewed this quarterly report on Form 10-Q of Monarch Bank;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

(b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2005

Brad E. Schwartz
Executive Vice President & Chief Financial Officer

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

In connection with the Quarterly Report on Form 10-Q of Monarch Bank (the "Bank") for the period ending September 30, 2005 as filed with the Federal Reserve Bank on the date hereof (the "Report"), I, William F. Rountree, Chief Executive Officer of the Bank, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 8, 2005

William F. Rountree, Jr.,
Chief Executive Officer

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

In connection with the Quarterly Report on Form 10-Q of Monarch Bank (the "Bank") for the period ending September 30, 2004 as filed with the Federal Reserve Bank on the date hereof (the "Report"), I, Brad E. Schwartz, Executive Vice President and Chief Financial Officer of the Bank, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 8, 2005

Brad E. Schwartz
Executive Vice President and Chief Financial Officer