VSB BANCORP INC
Form 10QSB
November 14, 2006

UNITED STATES
SECURITY AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20849

FORM 10-QSB

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTER ENDED SEPTEMBER 30, 2006

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OF THE EXCHANGE ACT FOR THE TRANSITION PERIOD

COMMISSION FILE NUMBER 0-50237

VSB Bancorp, Inc.
(Name of Small Business Issuer in its charter)

New York
(State or other jurisdiction of incorporation or organization)

11 - 3680128
(I. R. S. Employer Identification No.)

3155 Amboy Road, Staten Island, New York 10306
(Address of principal executive offices)

(718) 979-1100
Issuer's telephone number

Common Stock
(Title of Class)

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 [X] No [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes [ ] No [X]

Transitional small business disclosure format: Yes [ ] No [X]

The Registrant had 1,891,759 common shares outstanding as of October 27, 2006.

CROSS REFERENCE INDEX

PART I

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Forward-Looking Statements

When used in this periodic report, or in any written or oral statement made by us or our officers, directors or employees, the words and phrases "will result," "expect," "will continue," "anticipate," "estimate," "project," or similar terms are intended to identify "forward-looking statements." A variety of factors could cause our actual results and experiences to differ materially from the anticipated results or other expectations expressed in any forward-looking statements. Some of the risks and uncertainties that may affect our operations, performance, development and results, the interest rate sensitivity of our assets and liabilities, and the adequacy of our loan loss allowance, include, but are not limited to:

- deterioration in local, regional, national or global economic conditions which could result in, among other things, an increase in loan delinquencies, a decrease in property values, or a change in the real estate turnover rate;
- changes in market interest rates or changes in the speed at which market interest rates change;
- changes in laws and regulations affecting the financial service industry;
- changes in competition; and
- changes in consumer preferences by our customers or the customers of our business borrowers.

Please do not place undue reliance on any forward-looking statement, which speaks only as of the date made. There are many factors, including those described above, that could affect our future business activities or financial performance and could cause our actual future results or circumstances to differ materially from those we anticipate or project. We do not undertake any obligation to update any forward-looking statement after it is made.

VSB Bancorp, Inc.
Consolidated Statements of Financial Condition
(unaudited)

	September 30, 2006	December 31, 2005
Assets:		
Cash and due from banks	$ 36,054,385	$ 31,324,147
Investment securities, available for sale	113,888,922	106,023,293
Loans receivable	66,171,876	73,944,105
Allowance for loan loss	(1,193,024)	(1,153,298)
Loans receivable, net	64,978,852	72,790,807
Bank premises and equipment, net	1,641,558	1,441,087
Accrued interest receivable	821,129	728,627
Deferred taxes	2,268,664	2,298,195
Other assets	2,219,179	1,169,556
Total assets	$ 221,872,689	$ 215,775,712
Liabilities and stockholders' equity:		
Liabilities:		
Deposits:		
Demand and checking	$ 72,944,352	$ 66,692,436
NOW	20,433,030	23,574,056
Money market	16,743,027	20,177,240
Savings	13,208,697	14,809,010
Time	73,690,729	67,731,273
Total Deposits	197,019,835	192,984,015
Escrow deposits	371,654	267,144
Subordinated debt	5,155,000	5,155,000
Accounts payable and accrued expenses	2,533,909	2,553,208
Total liabilities	205,080,398	200,959,367
Employee Stock Ownership Plan Repurchase Obligation	259,532	284,411
Stockholders' equity:		
Common stock, ($.0001 par value, 3,000,000 shares authorized, 1,891,759 issued and outstanding at September 30, 2006 and 1,509,822 issued and outstanding at December 31, 2005)	189	151
Additional paid in capital	8,812,500	8,743,200
Retained earnings	10,443,503	8,621,693
Unallocated ESOP Shares	(1,282,175)	(1,408,983)
Accumulated other comprehensive loss, net of taxes of $1,257,222 and $1,242,278, respectively	(1,441,258)	(1,424,127)
Total stockholders' equity	16,532,759	14,531,934

Total liabilities and stockholders' equity	$ 221,872,689	$ 215,775,712

See notes to consolidated financial statements.

VSB Bancorp, Inc.
Consolidated Statements of Operations
(unaudited)

	Three months ended Sep. 30, 2006	Three months ended Sep. 30, 2005	Nine months ended Sep. 30, 2006	Nine m end Sep. 30
Interest and dividend income:				
Loans receivable	$ 1,794,879	$ 1,540,973	$ 5,301,788	$ 4,1
Investment securities	1,336,087	1,160,153	3,862,518	3,7
Other interest earning assets	282,049	171,029	594,676	3
Total interest income	3,413,015	2,872,155	9,758,982	8,2
Interest expense:				
NOW	27,867	28,455	77,512	
Money market	85,246	55,768	264,909	1
Savings	23,607	20,897	62,985	
Subordinated debt	89,040	89,040	267,119	2
Time	662,769	330,917	1,647,723	7
Other interest expense	1,112	--	1,112	
Total interest expense	889,641	525,077	2,321,360	1,3
Net interest income	2,523,374	2,347,078	7,437,622	6,8
Provision (credit) for loan loss	(25,000)	(15,000)	--	(
Net interest income after provision for loan loss	2,548,374	2,362,078	7,437,622	6,9
Non-interest income:				
Loan fees	16,973	22,914	57,273	
Service charges on deposits	366,716	450,172	1,143,444	1,2
Net rental income	1,083	149,129	7,832	1
Other income	62,151	49,259	200,395	1
Total non-interest income	446,923	671,474	1,408,944	1,6
Non-interest expenses:				
Salaries and benefits	909,308	958,331	2,911,028	2,8
Occupancy expenses	275,324	238,295	814,374	7
Legal expense	117,258	84,057	279,579	1
Professional fees	46,000	51,000	136,000	1
Computer expense	69,611	62,045	192,236	1
Directors' fees	53,950	39,900	167,400	1
Other expenses	317,875	368,568	934,915	8

Total non-interest expenses	1,789,326	1,802,196	5,435,532	5,0
Income before income taxes	1,205,971	1,231,356	3,411,034	3,5
Provision/(benefit) for income taxes:				
Current	515,262	580,100	1,544,749	1,6
Deferred	46,580	(6,318)	44,475	
Total provision for income taxes	561,842	573,782	1,589,224	1,6
Net income	$ 644,129	$ 657,574	$ 1,821,810	$ 1,9
Basic income per common share	$ 0.35	$ 0.36	$ 1.00	$
Diluted net income per share	$ 0.34	$ 0.35	$ 0.98	$
Comprehensive income	$ 1,606,183	$ 75,955	$ 1,804,679	$ 1,2
Book value per common share	$ 8.88	$ 7.63	$ 8.88	$

All per share data has been adjusted for the 5 for 4 stock split, in the form of a 25% stock dividend, paid on May 18, 2006. See notes to consolidated financial statements.

VSB Bancorp, Inc.
Consolidated Statements of Changes in Stockholders' Equity
Year Ended December 31, 2005 and Nine Months Ended September 30,
(unaudited)

	Number of Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Unallocat ESOP Shares
Balance at December 31, 2004	1,505,022	$ 150	$ 8,818,313	$ 6,054,264	$ (1,578,
Exercise of stock option	4,800	1	63,731		
Amortization of earned portion of ESOP common stock					169,
Amortization of excess fair value over cost - ESOP			18,742		
Transfer from ESOP repurchase obligation			(157,586)		
Comprehensive income:					
Net income				2,567,429	
Other comprehensive					

income, net:					
Unrealized holding loss arising during the year	--	--	--	--	
Total comprehensive income					
Balance at December 31, 2005	1,509,822	$ 151	$ 8,743,200	$ 8,621,693	$ (1,408,
Exercise of stock option	3,750		46,232		
Amortization of earned portion of ESOP common stock					126,
5 for 4 stock split and purchase of fractional shares	378,187	38	(367)		
Amortization of excess fair value over cost - ESOP			(1,444)		
Transfer from ESOP repurchase obligation			24,879		
Comprehensive income:					
Net income				1,821,810	
Other comprehensive income, net:					
Unrealized holding loss arising during the year	--	--	--	--	
Total comprehensive income					
Balance at September 30, 2006	1,891,759	$ 189	$ 8,812,500	$ 10,443,503	$ (1,282,

All per share data has been adjusted for the 5 for 4 stock split, in the form of a 25% stock dividend, paid on May 18, 2006. See notes to consolidated financial statements.

VSB Banco
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	Three months ended Sep. 30, 2006	Three months ended Sep. 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 644,129	$ 657,574
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	112,586	110,658
Accretion of income, net of amortization of premium	(66,629)	(48,290)
ESOP compensation expense	41,344	41,222
Provision/(credit) for loan losses	(25,000)	(15,000)

Increase in prepaid and other assets	(722,076)	(79,202)
Decrease/(increase) in accrued interest receivable	9,338	30,375
Decrease/(increase) in deferred income taxes	46,580	(6,318)
Increase/(decrease) in accrued expenses and other liabilities	338,455	899,019
Net cash provided by operating activities	378,727	1,590,038
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease/(increase) in loan receivable	5,808,450	202,071
Proceeds from repayment of investment securities, available for sale	5,909,777	7,784,233
Purchases of investment securities, afs	--	--
Purchases of premises and equipment	(41,271)	(22,137)
Net cash provided by/(used in) investing activities	11,676,956	7,964,167
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (decrease)/increase in deposits	(3,834,277)	8,253,655
Exercise stock option	4,062	22,956
5 for 4 stock split and the purchase of fractional shares	--	--
Net cash (used in)/provided by financing activities	(3,830,215)	8,276,611
NET INCREASE IN CASH AND CASH EQUIVALENTS	8,225,468	17,830,816
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	27,828,917	24,598,792
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 36,054,385	$ 42,429,608
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 731,263	$ 734,962
Taxes	$ 450,000	$ 554,897

See notes to consolidated financial statements.

VSB Bancorp, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (UNAUDITED)

1. GENERAL

VSB Bancorp, Inc. ("Bancorp" or "Company") became the holding company for Victory State Bank ("Bank"), a New York State chartered commercial bank on May

30, 2003 as the result of a reorganization of the Bank into the holding company form of organization. Through the Bank, the Company is primarily engaged in the business of commercial banking, and to a lesser extent retail banking, in Staten Island New York. The stockholders of the Bank became the stockholders of VSB Bancorp, Inc. as a result of the reorganization, receiving three shares of VSB Bancorp, Inc. stock for each two shares of Victory State Bank stock. Each stockholder owned the same percentage interest in VSB Bancorp immediately after the reorganization that the stockholder owned in the Bank immediately before the reorganization, subject to immaterial differences due to adjustments for cash in lieu of fractional shares. VSB Bancorp now owns 100% of the capital stock of the Bank. No stockholders of the Bank exercised dissenter's rights to receive cash instead of shares of the Company. The transaction between these entities under common control was accounted for at historical cost on an "as if pooled basis".

Through the Bank, the Company is primarily engaged in the business of commercial banking, and to a lesser extent retail banking. The Bank gathers deposits from individuals and businesses primarily in Staten Island, New York and makes loans throughout that community. The Bank invests funds that are not used for lending primarily in government securities, mortgage backed securities and collateralized mortgage obligations. Customer deposits are insured, up to the applicable limit, by the Federal Deposit Insurance Corporation ("FDIC"). The Bank is supervised by the New York State Banking Department and the FDIC.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a description of the significant accounting and reporting policies followed in preparing and presenting the accompanying consolidated financial statements. These policies conform with accounting principles generally accepted in the United States of America ("GAAP").

Principles of Consolidation - The consolidated financial statements of the Company include the accounts of the Company, including its subsidiary Victory State Bank. All significant inter-company accounts and transactions between the Company and Bank have been eliminated in consolidation.

Interim Financial Reporting - The unaudited condensed consolidated financial statements of the Company have been prepared pursuant to the rules and regulations for report on Form 10-QSB. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Form 10-KSB for the year ended December 31, 2005.

Use of Estimates - The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting period. Actual results can differ from those estimates. The allowance for loan losses, prepayment estimates on the mortgage-backed securities and Collateralized Mortgage Obligation portfolios, contingencies and fair values of financial instruments are particularly subject to change.

Reclassifications - Some items in the prior year financial statements were reclassified to conform to the current presentation.

Cash and Cash Equivalents - Cash and cash equivalents consists of cash on hand, due from banks and interest-bearing deposits. Net cash flows are reported

for customer loan and deposit transactions and interest-bearing deposits. Regulation D of the Board of Governors of the Federal Reserve system requires that Victory State Bank maintain non-interest-bearing deposits or cash on hand as reserves against its demand deposits. The amount of reserves which Victory State Bank is required to maintain depends upon its level of transaction accounts. During the fourteen day period from September 28, 2006 through October 11, 2006, Victory State Bank was required to maintain reserves, after deducting vault cash, of $3,778,000. Reserves are required to be maintained on a fourteen day basis, so, from time to time, Victory State Bank may use available cash reserves on a day to day basis, so long as the fourteen day average reserves satisfy Regulation D requirements. Victory State Bank is required to report transaction account levels to the Federal Reserve on a weekly basis.

Interest-bearing bank balances - Interest-bearing bank balances mature overnight and are carried at cost.

Investment Securities, Available for Sale - Investment securities, available for sale, are to be held for an unspecified period of time and include securities that management intends to use as part of its asset/liability strategy. These securities may be sold in response to changes in interest rates, prepayments or other factors and are carried at estimated fair value. Gains or losses on the sale of such securities are determined by the specific identification method. Interest income includes amortization of purchase premium and accretion of purchase discount. Premiums and discounts are recognized in interest income using a method that approximates the level yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are estimated. Unrealized holding gains or losses, net of deferred income taxes, are excluded from earnings and reported as other comprehensive income in a separate component of stockholders' equity until realized. Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

The Company invests primarily in agency Collateralized Mortgage-Backed Obligations ("CMOs") with estimated average lives primarily under 4.5 years and Mortgage-Backed Securities. These securities are primarily issued by the Federal National Mortgage Association ("FNMA"), the Government National Mortgage Association ("GNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC") and are primarily comprised of mortgage pools guaranteed by FNMA, GNMA or FHLMC. The Company also invests in whole loan CMOs, all of which are AAA rated. These securities expose the Company to risks such as interest rate, prepayment and credit risk and thus pay a higher rate of return than comparable treasury issues.

Loans Receivable - Loans receivable, that management has the intent and ability to hold for the foreseeable future or until maturity or payoff, are stated at unpaid principal balances, adjusted for deferred net origination and commitment fees and the allowance for loan losses. Interest income on loans is credited as earned.

It is the policy of the Company to provide a valuation allowance for probable incurred losses on loans based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations which may affect the borrower's ability to repay, estimated value of underlying collateral and current economic conditions in the Company's lending area. The allowance is increased by provisions for loan losses charged to earnings and is reduced by charge-offs, net of recoveries. While management uses available information to estimate losses on loans, future additions to the allowance may be necessary based upon the expected growth of the loan portfolio and any

changes in economic conditions beyond management's control. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on judgments different from those of management. Management believes, based upon all relevant and available information, that the allowance for loan losses is adequate.

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The Company has a policy that all loans 90 days past due are placed on non-accrual status. It is the Company's policy to cease the accrual of interest on loans to borrowers past due less than 90 days where a probable loss is estimated and to reverse out of income all interest that is due. The Company applies payments received on non-accrual loans to the outstanding principal balance due. On a limited basis, the Company may apply a payment to interest on a non-accrual loan if there is no impairment or no estimatible loss on this asset. The Company continues to accrue interest on construction loans that are 90 days past contractual maturity date if the loan is expected to be paid in full in the next 60 days and all interest is paid up to date.

Loan origination fees and certain direct loan origination costs are deferred and the net amount recognized over the contractual loan terms using the level-yield method, adjusted for periodic prepayments in certain circumstances.

The Company considers a loan to be impaired when, based on current information, it is probable that the Company will be unable to collect all principal and interest payments due according to the contractual terms of the loan agreement. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Impairment is measured on a loan by loan basis for commercial and construction loans. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral. The fair value of the collateral, as reduced by costs to sell, is utilized if a loan is collateral dependent. Large groups of smaller balance homogeneous loans, such as consumer loans and residential loans, are collectively evaluated for impairment.

Long-Lived Assets - The Company periodically evaluates the recoverability of long-lived assets, such as premises and equipment, to ensure the carrying value has not been impaired. In performing the review for recoverability, the Company would estimate the future cash flows expected to result from the use of the asset. If the sum of the expected future cash flows is less than the carrying amount an impairment will be recognized. The Company reports these assets at the lower of the carrying value or fair value.

Subordinated Debt - In August of 2003, the Company formed VSB Capital Trust I (the "Trust"). The Trust is a statutory business trust organized under Delaware law and the Company owns all of its common securities. The Trust issued $5.0 million of Trust Preferred Capital Securities to an independent investor and $155,000 of common securities to the Company. The Company issued a $5.16 million subordinated debenture to the Trust. The subordinated debenture is the sole asset of the Trust. The subordinated debenture and the Trust Preferred Capital Securities pay interest and dividends, respectively, on a quarterly basis, at a rate of 6.909%, for the first five years. They mature thirty years after the issuance of the securities and are non-callable for five years. After the first five years, the Trust Preferred Securities may be called by the Company at any quarterly interest payment date at par and the rate of interest that fluctuates quarterly based upon 300 basis points over the 90 day LIBOR rate. The Trust is not consolidated with the Company.

Premises and Equipment - Premises, leasehold improvements, and furniture

and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are accumulated by the straight-line method over the estimated useful lives of the respective assets, which range from three to ten years. Leasehold improvements are amortized at the lesser of their useful life or the term of the lease.

Federal Home Loan Bank (FHLB) Stock - The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment. Because this stock is viewed as a long term investment, impairment is based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Income Taxes - The Company utilizes the liability method to account for income taxes. Under this method, deferred tax assets and liabilities are determined on differences between financial reporting and the tax bases of

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assets and liabilities and are measured using the enacted tax rates and laws expected to be in effect when the differences are expected to reverse. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Financial Instruments - In the ordinary course of business, the Company has entered into off-balance sheet financial instruments, primarily consisting of commitments to extend credit.

Basic and Diluted Net Income Per Common Share - Basic net income per share of common stock is based on 1,821,357 shares and 1,805,362 shares, the weighted average number of common shares outstanding for the three months ended September 30, 2006 and 2005, respectively. Diluted net income per share of common stock is based on 1,868,460 and 1,861,308, the weighted average number of common shares and potentially dilutive common shares outstanding for the three months ended September 30, 2006 and 2005, respectively. The weighted average number of potentially dilutive common shares excluded in calculating diluted net income per common share due to the anti-dilutive effect is 85,397 and 72,645 shares for the three months ended September 30, 2006 and 2005, respectively. Common stock equivalents were calculated using the treasury stock method. All per share data throughout this report has been adjusted to reflect, retroactively, a 5-for-4 stock split, in the form of a 25% stock dividend, that was declared by the Board of Directors to stockholders of record on May 3, 2006.

Basic net income per share of common stock is based on 1,816,840 shares and 1,800,512 shares, the weighted average number of common shares outstanding for the nine months ended September 30, 2006 and 2005, respectively. Diluted net income per share of common stock is based on 1,865,575 and 1,860,815, the weighted average number of common shares and potentially dilutive common shares outstanding for the nine months ended September 30, 2006 and 2005, respectively. The weighted average number of potentially dilutive common shares excluded in calculating diluted net income per common share due to the anti-dilutive effect is 84,070 and 71,190 shares for the nine months ended September 30, 2006 and 2005, respectively. Common stock equivalents were calculated using the treasury stock method. All per share data throughout this report has been adjusted to reflect, retroactively, a 5-for-4 stock split, in the form of a 25% stock dividend that was declared by the Board of Directors to stockholders of record on May 3, 2006.

The reconciliation of the numerators and the denominators of the basic and diluted per share computations for the three and nine months ended September 30,

are as follows:

Reconciliation of EPS	Three Months Ended September 30, 2006			Three Months September 30	
	Net Income	Weighted Average Shares	Per Share Amount	Net Income	Weighte Averag Shares
Basic income per common share					
Net income available to common stockholders	$ 644,129	1,821,357	$ 0.35	$ 657,574	1,805,
Effect of dilutive shares					
Weighted average shares, if converted		47,103			55,
Diluted net income per common share					
Net income available to common stockholders	$ 644,129	1,868,460	$ 0.34	$ 657,574	1,861,

Reconciliation of EPS	Nine Months Ended September 30, 2006			Nine Months September 30	
	Net Income	Weighted Average Shares	Per Share Amount	Net Income	Weighte Averag Shares
Basic income per common share					
Net income available to common stockholders	$ 1,821,810	1,816,840	$ 1.00	$ 1,921,827	1,800,
Effect of dilutive shares					
Weighted average shares, if converted		48,735			60,
Diluted net income per common share					

Net income available to common stockholders	$ 1,821,810	1,865,575	$ 0.98	$ 1,921,827	1,860,

All per share data has been adjusted for the 5 for 4 stock split, in the form of a 25% stock dividend, paid on May 18, 2006.

Stock Based Compensation - FAS 123, Revised, required companies to record compensation expense for stock options provided to employees in return for employment service. The cost is measured at the fair value of the options when granted, and this cost is expensed over the employment service period, which is normally the vesting period of the options. This applies to awards granted or modified in fiscal years beginning in 2006. Compensation cost will also be recorded for prior option grants that vest after the date of adoption. The effect of result on operations will depend on the level of future option grants and the calculation of the fair value of the options granted at such future date, as well as the vesting periods provided, and so cannot currently be predicted. In December 2005, the Board authorized the acceleration of the vesting of all outstanding stock options issued to both employees and directors. The decision to accelerate the vesting of these options, which the Company believes is in the best interest of its stockholders, was made primarily to

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reduce non-cash compensation expense, approximately $169,000 of future compensation expense, net of taxes, that would have been recorded in its income statement in future periods upon the adoption of Financial Accounting Standards Board Statement No. 123R (Share-Based Payment) in January 2006.

If compensation cost for awards had been measured based on the fair value of the stock options awarded at the grant dates, net income and basic and diluted earnings per common share would have been reduced to the pro-forma amounts on the table below for the three and nine months ended September 30, 2005:

	Three Months Ended Sep. 30, 2005	Nine Months Ended Sep. 30, 2005
Net Income		
As reported	$ 657,574	$ 1,921,827
Less: Total stock-based compensation expense determined under the fair value method for all awards, net of related tax effects	13,513	40,539
Pro-forma	$ 644,061	$ 1,881,288

	Three Months Ended Sep. 30, 2005	Nine Months Ended Sep. 30, 2005
Basic earnings per common share		
As reported	$ 0.36	$ 1.07
Less: Total stock-based compensation expense		

determined under the fair value method for all awards, net of related tax effects	--	0.03
Pro-forma	$ 0.36	$ 1.04

	Three Months Ended Sep. 30, 2005	Nine Months Ended Sep. 30, 2005
Diluted earnings per common share		
As reported	$ 0.35	$ 1.03
Less: Total stock-based compensation expense determined under the fair value method for all awards, net of related tax effects	--	0.02
Pro-forma	$ 0.35	$ 1.01

All per share data throughout this report has been adjusted to reflect, retroactively, a 5 for 4 stock split, in the form of a 25% stock dividend, that was declared by the Board of Directors to stockholders of record on May 3, 2006.

Stock Options

Options to buy stock are granted to directors, officers and employees under the VSB Bancorp, Inc. 2000 Incentive Plan, the 1998 Incentive Plan, the 2004 Directors' Plan, the 2000 Directors' Plan and the 1998 Directors' Plan which, in the aggregate, provide for issue up to 243,750 options. Exercise price is the market price at the date of grant, and compensation expense will be recognized in the income statement in accordance with FAS 123, Revised. The maximum option term is ten years, and the options vesting period is up to five years.

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As of December 31, 2005 the Board accelerated the vesting on all outstanding options so that they became immediately exercisable. By accelerating the vesting of these options, we estimated that approximately $169,000 of future compensation expense, net of taxes, was eliminated.

There were no stock option grants in 2006 and 2005.

The stock option components of the 2000 Incentive Plan, the 1998 Incentive Plan and the 2004 Directors' Plan, the 2000 Directors' Plan and the 1998 Directors' Plan, as of September 30, 2006, and changes during the nine months ended, consist of the following:

	2006		
	Shares (2)	Weighted Average Exercise Price (2)	Aggregate Intrinsic Value (1)

Options outstanding at the beginning of the year	182,498	$ 10.31	
Granted	--	--	
Canceled	--	--	
Exercised	4,500	6.24	
Options outstanding at September 30, 2006	177,998	$ 10.36	$ 817,011
Options exercisable at September 30, 2006	177,998	$ 10.36	$ 817,011

Weighted average remaining contractual life of options outstanding at September 30, 2006 5.0 Years

(1) The aggregate intrinsic value is determined by taking the difference between the closing price at September 30, 2006 ($14.95, as adjusted for the 5 for 4 stock split) and the weighted average exercise price and then multiplying the result by the options outstanding at September 30, 2006.

(2) All share and per share data throughout this report has been adjusted to reflect, retroactively, a 5 for 4 stock split, in the form of a 25% stock dividend, that was declared by the Board of Directors to stockholders of record on May 3, 2006.

Described below is the range of exercise prices for options granted under the following option plans as of September 30, 2006:

Plan Description	Range of Exercise Prices	Number of Exercisable Shares	Weighte Exerci
1998 Director Stock Option Plan	From $4.90 to $6.40	23,750	$
1998 Incentive Stock Option Plan	From $4.75 to $6.40	32,500	
2000 Director Stock Option Plan	$4.75	25,000	
2000 Incentive Stock Option Plan	$4.75 and $15.60	41,748	
2004 Director Stock Option Plan	$17.60	55,000	
All Plans		177,998	$

All share and per share data throughout this report has been adjusted to reflect, retroactively, a 5 for 4 stock split, in the form of a 25% stock dividend, that was declared by the Board of Directors to stockholders of record on May 3, 2006.

Employee Stock Ownership Plan ("ESOP") - The cost of shares issued to the ESOP, but not yet allocated to participants, is shown as a reduction of stockholders' equity. Compensation expense is based on the market price of shares as they are committed to be released to participant accounts. Cash dividends on allocated ESOP shares reduce retained earnings; cash dividends on unearned ESOP shares reduce debt and accrued interest. As participants may put

their ESOP shares back to the Company upon termination, an amount of equity equal to these shares times the current market price is reclassified out of stockholders' equity.

Comprehensive Income - Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses, net of taxes, on securities available for sale which are also recognized as separate components of equity.

Recently-Issued Accounting Standards - In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. Prior to SAB 108, companies might evaluate the materiality of financial statement misstatements using either the income statement or balance sheet approach, with the income statement approach focusing on new misstatements added in the current year, and the balance sheet approach focusing on the cumulative amount of misstatement present in a company's balance sheet. Misstatements that would be material under one approach could be viewed as immaterial under another approach, and not be corrected. SAB 108 now requires that companies view financial statement misstatements as material if they are material according to either the income statement or balance sheet approach. This statement is effective as of the end of the fiscal year ending after December 15, 2006. The Company is currently evaluating the impact of adopting SAB 108 on the consolidated financial statements.

In June 2006, Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. ("FIN") 48, Accounting for Uncertainty in Income Taxes. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of adopting FIN 48 on the consolidated financial statements.

In February 2006, FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Instruments. This standard amended the guidance in FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Statement 155 permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and clarifies which interest-only and principal-only strips are not subject to the requirements of Statement 133. Statement 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In March 2006, FASB issued Statement No. 156, Accounting for Servicing of Financial Assets - An Amendment of FASB Statement No. 140. This standard amends the guidance in Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities with respect to the accounting for separately recognized servicing assets and servicing liabilities. Among other requirements, Statement 156 requires an entity to recognize a

servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations, including a transfer of the servicing loans that meets the requirements for sale accounting. Statement 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In September 2006, FASB issued Statement No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This

Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

Item 2

Management's Discussion and Analysis of Financial Condition and Results of Operations

Financial Condition at September 30, 2006

Total assets were $221,872,689 at September 30, 2006, an increase of $6,096,977 or, 2.8%, from December 31, 2005. The increase was due to the investment of the proceeds of a $10 million New York State jumbo CD deposit and a $10 million New York City jumbo CD deposit we received in connection with the opening of our Rosebank branch under the state's and city's Bank Development District programs. There is a non-binding commitment from the municipalities to renew these CDs for two years and the interest rates are adjusted periodically during that time. The deposit increase from these two CDs was partially offset by the reduction in the balance of jumbo CDs that were opened in conjunction with the establishment of various IRS Section 1031 exchange trusts, which have a maximum maturity of 6 months. The net increase in deposits provided funds for us to invest. We invested these funds, together with funds resulting from a $7,811,955 decrease in net loans receivable, primarily in investment securities available for sale, which increased by $7,865,629. We purchased investment securities, in part, to offset the decline in loans and to increase investment collateral available to pledge for the municipal CD deposits.

Our deposits (including escrow deposits) were $197,391,489 at September 30, 2006, an increase of $4,140,330, or 2.1%, from December 31, 2005. The increase in deposits resulted from increases of $6,356,426 in non-interest demand deposits and $5,959,456 in time deposits, partially offset by decreases of $3,141,026 in NOW accounts, $1,600,313 in savings accounts and $3,434,213 in money market accounts. The net increase in time deposits was primarily attributed to the $20 million in municipal CDs, partially offset by the decline in IRS Section 1031 exchange trust deposits, as discussed above. These trusts are created by attorneys in real estate transactions. The deposits have a maximum term of six months and cannot be renewed. Our ability to attract these deposits tends to fluctuate with activity in the real estate markets and competitive pressures, so the volume of these deposits tends to fluctuate from

period to period more dramatically than other types of deposits.

Total stockholders' equity was $16,532,759 at September 30, 2006, an increase of $2,000,825 from December 31, 2005. The increase reflected net income of $1,821,810 for the nine months ended September 30, 2006, reduced by an increase of $17,131 in other comprehensive loss, due to an increase in the unrealized loss in securities available for sale during the first nine months of 2006. The unrealized loss increased due to the increase in market interest rates, which reduced the market value of our fixed rate bond portfolio. This unrealized loss is excluded from the calculation of regulatory capital. Management does not anticipate selling securities in this portfolio, but changes in market interest rates or in the demand for funds may change management's plans with respect to the securities portfolio. If there is a material increase in interest rates, the market value of the available for sale portfolio may decline further. Management believes that the principal and interest payments on this portfolio, combined with the existing liquidity, will be sufficient to fund potential loan growth and deposit outflow.

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The change in stockholders' equity also included an increase of $69,300 in additional paid in capital primarily due to the receipt of $46,232 upon the exercise of stock options under our stock option plans and a $24,879 decrease in the magnitude of our statutorily mandated ESOP repurchase obligation caused by a decrease in our stock price and the distribution of ESOP shares to eligible participants. We also reported a decrease in unearned ESOP shares of $126,808 reflecting the effect of the gradual payment of the loan we made to fund the ESOP's purchase of our stock.

For financial statement reporting purposes, we record the compensation expense related to the ESOP when shares are committed to be released from the security interest for the loan. The amount of the compensation expense is based upon the fair market value of the shares at that time, not the original purchase price. The initial sale of shares to the ESOP did not increase our capital by the amount of the purchase price because the purchase price was paid by the loan we made to the ESOP. Instead, capital increases as the shares are allocated or committed to be allocated to employee accounts (i.e., as the ESOP loan is gradually repaid), based upon the fair market value of the shares at that time. When we calculate earnings per share, only shares allocated or committed to be allocated to employee accounts are considered to be outstanding. However, all shares that the ESOP owns are legally outstanding, so they have voting rights and, if we pay dividends, dividends will be paid on all ESOP shares.

Results of Operations for the Three Months Ended September 30, 2006 and September 30, 2005

Our results of operations are dependent primarily on net interest income, which is the difference between the income we earn on our loan and investment portfolios and our cost of funds, consisting primarily of interest we pay on customer deposits. Our operating expenses principally consist of employee compensation and benefits, occupancy expenses, professional fees, advertising and marketing expenses and other general and administrative expenses. Our results of operations are significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory authorities.

General. We had net income of $644,129 for the quarter ended September 30, 2006, compared to net income of $657,574 for the comparable quarter in 2005. The principal categories which make up the 2006 net income are:

- Interest income of $3,413,015

- o Reduced by interest expense of $889,641
- o Increased by a credit to the provision for loan losses of $25,000
- o Increased by non-interest income of $446,923
- o Reduced by non-interest expense of $1,789,326
- o Reduced by $561,842 in income tax expense

We discuss each of these categories individually and the reasons for the differences between the quarters ended September 30, 2006 and 2005 in the following paragraphs.

Interest Income. Interest income was $3,413,015 for the quarter ended September 30, 2006, compared to $2,872,155 for the quarter ended September 30, 2005, an increase of $540,860, or 18.83%. We accomplished the increase in interest income principally because of increases in the yields on our prime-based loans, which make up most of our loan portfolio, and to a lesser degree the increase in yield on our investment securities and other interest-earning assets. An increase in total average interest-earning assets of $2,140,344, or 1.0%, also added additional interest income. The increase in average interest-earning assets was composed of an increase in average balances of $5,573,185 in the investment securities portfolio and $1,660,947 in other interest earning assets, offset by a decrease in average balance of the loan portfolio of $5,093,788.

The yields on all principal asset categories increased as the Fed Funds rate increased, causing increases in other interest rate indexes, such as the prime rate, and market interest rates generally. The yields on our loan portfolio and our other interest earning assets, principally short term liquid assets, increased more rapidly than the yield on our investment securities. This occurred because most of our loans and liquid assets tend to have interest rates that adjust more quickly as market interest rates change while the rates we earn on our investment securities are primarily either fixed rates or rates that adjust at less frequent intervals than our the rates on our loans.

The average balance of our loans decreased to $69,220,537 for the quarter ended September 30, 2006 from $74,314,325, or 6.85%, during the 2005 quarter. The decrease in average balance reflects the volatility inherent in the shorter maturity loans coupled with the increase in competition for such loans and the general softening of the real estate market. The average yield on loans increased by 200 basis points, from 8.19% to 10.19%, as the prime rate rose. The interest rates on all of our prime-based loans are above their interest rate floors and will generally re-price upwards in the event of future increases in the prime rate, but a decline in the prime rate will also now result in a decline in loan yields until loan rates drop to the interest rate floors. The effect of the increase in yield, partially offset by the effect of the decline in average balance, was a $253,906 increase in interest income from our loan portfolio.

The average yield on our investment securities portfolio increased 40 basis points, from 4.16% to 4.56%, also due to increases in market interest rates. The yield on investment securities increased more slowly than the yield on loans because our loans tend to have significantly shorter average terms to maturity or repricing than the bonds in our investment portfolio. The average balance of our investment portfolio increased by $5,573,185, or 5.04%, between the periods. We purchased additional investment securities because we needed more collateral to pledge against deposits. The increase in yield and volume resulted in an overall $175,934 increase in interest income from investment securities. The investment securities portfolio represented 83.9% of average non-loan interest earning assets in the 2006 period compared to 84.3% in the 2005 period.

Finally, we had an $111,020 increase in income from overnight funds and other interest earning assets due to the higher market rates on short term and overnight investments. The yield on these investments increased 173 basis points from the third quarter of 2005 to the third quarter of 2006, reflecting the rise in the federal funds rate. We increased the average balance of overnight investments because they provide us with greater reinvestment flexibility and the gap between the rates on those investments versus the rates on investment securities narrowed as short-term market rates rose while longer term rates remained more steady.

Interest Expense. Interest expense was $889,641 for the quarter ended September 30, 2006, compared to $525,077 for the quarter ended September 30, 2005, an increase of 69.4%. The increase was primarily the result of an increase in the rates we paid on deposits, coupled with increases in the average balance of interest-bearing deposits, primarily time deposits. The average balance of time deposits increased more rapidly than other interest-bearing deposits because it includes the $20 million of municipal CDs that we received in connection with the opening of our Rosebank branch. The increase caused by those municipal deposits was offset by the reduction in the average balance of large balance time deposit accounts for like-kind exchange trusts.

Our average cost of funds increased from 1.61% to 2.62% between the two periods, primarily due to an increase of 138 basis points in the average rate we paid on time deposits from 2.11% to 3.48%. In addition, time deposits, our highest cost deposits, increased from 47.9% of average interest bearing liabilities in the 2005 quarter to 56.2% in the 2006 quarter. Competition and the increase in prevailing market interest rates required an increase in the rates we offered on both new and renewing time deposits. While we were able to impose greater limits on interest rate increases in other deposit categories as market interest rates rose, further increases in market rates, if they occur, can be expected to compel increases in the rates we offer on these deposit categories to maintain our competitive posture. Any further increase in competition may accelerate the increase in our cost of funds resulting from increases in market interest rates as more banks compete for customer deposits.

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Net Interest Income Before Provision for Loan Losses. Net interest income before the provision for loan losses was $2,523,374 for the quarter ended September 30, 2006, an increase of $176,296, or 7.5% over the $2,347,078 in the comparable 2005 quarter. The increase was driven primarily by an increase in our yield on loans, and to a lesser extent the increase in the yields on other interest earning asset categories. These were partially offset by the increase in our cost of funds. Our net interest margin increased to 4.79% in the third quarter of 2006 compared to 4.52% in the third quarter of 2005, while our net interest spread decreased to 3.87% in the third quarter of 2006 compared to 3.92% in the third quarter of 2005, respectively. On the asset side, the average yield on earning assets in the 2006 period increased to 6.49% from 5.53% in the September 2005 period, or an increase of 96 basis points. On the liability side, there was an increase in our cost of funds of 101 basis points from 2005. In 2006, we were able to invest the monies generated by our demand deposit portfolio at higher yields than the yield available in 2005. This also helped to increase our net interest income and our net interest margin in 2006.

Our non-interest checking accounts, which represent a no-cost funding source, have declined recently. Management seeks to maintain a high level of non-interest checking accounts through developing relationships with local businesses. Maintaining a high percentage of non-interest checking accounts is particularly advantageous in a rising rate environment because these no-cost funds can be invested at the higher yields. However, increases in market

interest rates make interest-bearing deposit products more attractive to customers and may cause funds to shift from non-interest checking into interest-bearing deposit products.

Provision for Loan Losses. For the quarter ended September 30, 2006, we took a $25,000 credit to the provision for loan losses, compared to a $15,000 credit to the provision for loan losses for the quarter ended September 30, 2005. The credit to the provision for loan losses was due to the decline the loan portfolio balance and the level of recoveries on loans previously charged-off, which are added to the allowance for loan loss. The provision for loan losses in any period depends upon the amount necessary to bring the allowance for loan losses to the level management believes is adequate, after taking into account charge offs and recoveries. Our allowance for loan losses is based on management's evaluation of the risks inherent in our loan portfolio and the general economy. Management periodically evaluates both broad categories of performing loans and problem loans individually to assess the appropriate level of the allowance.

Although management uses available information to assess the adequacy of the allowance on a quarterly basis in consultation with outside advisors and the board of directors, changes in national or local economic conditions, the circumstances of individual borrowers, or other factors, may change, increasing the level of problem loans and requiring an increase in the level of the allowance. The allowance for loan loss represented 1.80% of total loans at September 30, 2006, but there can be no assurance that a higher level, or a higher provision for loan losses, will not be necessary in the future.

Non-interest Income. Non-interest income was $446,923 for the three months ended September 30, 2006, compared to $671,474 during the same period last year. The $224,551, or 33.4%, decrease in non-interest income was a direct result of a $12,892 increase in other income offset by a $148,046 decrease in net rental income and an $83,456 decrease in service charges on deposits (primarily non-sufficient fund fees). The increase in other income is a direct result of the Bank taking on a select, limited group of licensed consumer check cashing companies as deposit customers. These companies generate fee income through per item charges on their deposits. The decrease in net rental income was a direct result of a one-time buyout in 2005 of a sublease by one of the Bank's subtenants. Service fees on deposit accounts, principally non-sufficient funds fees, declined from 2005 to 2006 as customers reduced the frequency with which they overdrew their deposit accounts

Non-interest Expense. Non-interest expense was $1,789,326 for the quarter ended September 30, 2006, compared to $1,802,196 for the quarter ended September 30, 2005. The principal causes of the $12,870 decrease were:

- $49,023 decrease in salaries and benefits expense, due to a reduction in compensation expense related to Stock Appreciation Rights, offset by normal salary increases, a slight increase in staffing to support growth and higher benefit costs.
- $37,029 in higher occupancy expenses due to the opening of our fifth branch and the costs involved in the renting of our sixth branch location.
- $33,201 increase in legal expenses incurred in connection with a number of pending lawsuits involving a former customer of the Bank and other collection expenses.
- $50,693 decrease of "other expenses" primarily due to a $100,000 expense that occurred in 2005 for the establishment of a reserve for an unasserted claim, which was partially offset by 2006 pre-opening expenses for our planned sixth branch, which we expect to open in

early 2007.

Income Tax Expense. Income tax expense was $561,842 for the quarter ended September 30, 2006, compared to income tax expense of $573,782 for the quarter ended September 30, 2005. The reduction in income tax expense was due to the $25,385 decrease in income before income taxes in the 2006 quarter. Our effective tax rate remained the same for the quarters ended September 30, 2006 and 2005 at 46.6%.

Results of Operations for the Nine Months Ended September 30, 2006 and September 30, 2005

General. We had net income of $1,821,810 for the nine months ended September 30, 2006, compared to net income of $1,921,827 for the comparable period in 2005. The principal categories which make up the 2006 net income are:

- Interest income of $9,758,982
- Reduced by interest expense of $2,321,360
- Increased by non-interest income of $1,408,944
- Reduced by non-interest expense of $5,435,532
- Reduced by $1,589,224 in income tax expense

We discuss each of these categories individually and the reasons for the differences between the periods ended September 30, 2006 and 2005 in the following paragraphs.

Interest Income. Interest income was $9,758,982 for the nine months ended September 30, 2006, compared to $8,225,632 for the nine months ended September 30, 2005, an increase of $1,533,350, or 18.64%. We accomplished the increase in interest income, despite a decrease in total average interest-earning assets of $977,957, or 0.48%, principally because of increases in the yields on our prime-based loans, which make up most of our loan portfolio, and to a more limited extent, the increase in yield on investment securities and other interest earning assets. The decrease in average interest-earning assets was composed of a decrease in the average balance of investment securities of $3,983,079, partially offset by a $636,495 increase in the average balance of the loan portfolio and a $2,368,627 increase in other interest-earning assets.

The yields on all principal asset categories increased as the Fed Funds rate increased, causing increases in other interest rate indexes, such as the prime rate, and market interest rates generally. The yields on our loan portfolio and our other interest earning assets, principally short term liquid assets, increased more rapidly than the yield on our investment securities. This occurred because most of our loans and liquid assets tend to have interest rates that adjust more quickly as market interest rates change while the rates we earn on our investment securities are primarily either fixed rates or rates that adjust at less frequent intervals than the rates on our loans.

The average balance of our loans increased to $71,136,492 for the nine months ended September 30, 2006 from $70,499,997, or 0.90%, during the 2005 period. This slight increase generated a slight increase in interest income. The increase in average yield on loans was more significant, as loan yield increased by 198 basis points, from 7.93% to 9.91%, due to the prime rate increases in conjunction with the increases in the Fed Funds rate. The interest rates on all

of our prime-based loans have risen above their interest rate floors and have been adjusting as the prime rate adjusts. The combined effect of the increase in yield and the increase in average volume was a $1,107,846 increase in interest

income from our loan portfolio.

The average yield on our investment securities portfolio increased 32 basis points, from 4.23% to 4.55%, also due to increases in market interest rates, while the average balance of our investment portfolio declined by $3,983,079, or 3.39%, between the periods. The overall effect of the decline in volume coupled with the increase in yield resulted in a $147,117 increase in interest income from investment securities. The investment securities portfolio represented 86.9% of average non-loan interest earning assets in the first nine months of 2006 compared to 88.8% in the first nine months of 2005.

Finally, we had a $278,387 increase in income from overnight funds and other interest earning assets due to the higher market rates on short term and overnight investments. The yield on these investments increased 178 basis points from the first nine months of 2005 to the first nine months of 2006, reflecting the rise in the federal funds rate, and the average balance of increased $2,368,627, or 16.0%. We increased the average balance of overnight investments because they provide us with greater reinvestment flexibility and the gap between the rates on those investments versus the rates on investment securities narrowed as short-term market rates rose to a larger degree while longer-term rates rose at a more moderated pace.

Interest Expense. Interest expense was $2,321,360 for the nine months ended September 30, 2006, compared to $1,347,776 for the nine months ended September 30, 2005, an increase of 72.2%. The increase was primarily the result of an increase in the rates we paid on deposits, coupled with increases in the average balance of interest-bearing deposits, primarily time deposits. The average balance of time deposits increased more rapidly than other interest-bearing deposits because of the $20 million of municipal CDs, partially offset by the reduction in IRS Section 1031 like-kind exchange time deposits, both as discussed above.

Our average cost of funds increased from 1.45% to 2.39% between the two periods, primarily due to the effect of time deposits, our highest cost deposit category, on our overall cost of funds. Time deposits increased from 46.2% of average interest bearing liabilities in the 2005 period to 53.8% in the 2006 period. The average rate on these deposits increased 133 basis points from 1.83% in the 2005 period to 3.16% in the 2006 period. The increase in the rates we paid on deposits was caused by the combined effect of increases in market interest rates and increases in local competitive pressures. Competition and the increase in prevailing market interest rates required an increase in the rates we offered on both new and renewing time deposits and, to a lesser degree, the rates we paid on other deposit categories. We do not have and we do not seek brokered time deposits.

Net Interest Income Before Provision for Loan Losses. Net interest income before the provision for loan losses was $7,437,622 for the nine months ended September 30, 2006, an increase of $559,766, or 8.1% over the $6,877,856 in the comparable 2005 period. The increase was driven primarily by an increase in our yields on loans, investment securities and other interest earning assets, partially offset by an increase in our cost of funds. Our interest rate spread and net interest margin increased to 4.05% and 4.91% in the first nine months of 2006 compared to 3.96% and 4.53% in the first nine months of 2005, respectively. On the asset side, the average yield of earning assets in the 2006 period increased to 6.44% from 5.41% in the September 2005 period, or an increase of 103 basis points. On the liability side, there was an increase in our cost of funds of 94 basis points. The resulting 9 basis point improvement in spread was the result of the combined effect of increased market interest rates.

Our non-interest checking accounts have declined recently. Management seeks to maintain a high level of non-interest checking accounts through developing relationships with local businesses. Maintaining a high percentage of

non-interest checking accounts is particularly advantageous in a rising rate environment because these no-cost funds can be invested at the higher yields. However, an increase in market interest rates may make interest-bearing deposit products more attractive to customers and cause funds to shift from non-interest checking into interest-bearing deposit products.

Provision for Loan Losses. There was no provision for loan losses for the nine months ended September 30, 2006, compared to $90,000 credit to the provision for loan losses for the nine months ended September 30, 2005. The increase in the provision was primarily due to an increase in loan delinquencies at the beginning of the first nine months of 2006 but the charge to the provision was mitigated later in the period when the recovery of loans previously charged-off increased our allowance for loan losses. The provision for loan losses in any period depends upon the amount necessary to bring the allowance for loan losses to the level management believes is adequate, after taking into account charge offs and recoveries. Our allowance for loan losses is based on management's evaluation of the risks inherent in our loan portfolio and the general economy. Management periodically evaluates both broad categories of performing loans and problem loans individually to assess the appropriate level of the allowance.

Although management uses available information to assess the adequacy of the allowance on a quarterly basis in consultation with outside advisors and the board of directors, changes in national or local economic conditions, the circumstances of individual borrowers, or other factors, may change, increasing the level of problem loans and requiring an increase in the level of the allowance. The allowance for loan losses represented 1.80% of total loans at September 30, 2006, but there can be no assurance that a higher level, or a higher provision for loan losses, will not be necessary in the future.

Non-interest Income. Non-interest income was $1,408,944 for the nine months ended September 30, 2006, compared to $1,649,273 during the same period last year. The $240,329, or 14.6%, decrease in non-interest income was a direct result of a $96,643 increase in other income offset by a $151,335 decrease in service charges on deposits (primarily non-sufficient fund fees) and a $162,902 decrease in net rental income. The increase in other income is a direct result of per item charges on a limited group of licensed consumer check cashing companies we have recently added as deposit customers. Service fees on deposit accounts declined from 2005 to 2006 as the volume of deposit account transactions generating fee income declined. Service fees on deposit accounts, principally non-sufficient funds fees, declined from 2005 to 2006 as customers reduced the frequency with which they overdrew their deposit accounts. The decrease in net rental income was a result of a one-time buyout in 2005 of a sublease by one of the Bank's subtenants.

Non-interest Expense. Non-interest expense was $5,435,532 for the nine months ended September 30, 2006, compared to $5,018,586 for the nine months ended September 30, 2005. The principal causes of the $416,946 increase were:

- $78,947 in higher salary and benefits costs due to normal salary increases, an increase in staffing to support branch expansion and higher benefit costs.
- $89,337 in higher occupancy expenses due to the opening of our fifth branch and the rental expense of our planned sixth branch.
- $162,147 increase in higher legal expenses incurred in connection with a number of pending lawsuits involving a former customer of the Bank and increased collection expenses.
- $71,699 more of "other expenses," primarily opening expenses for our fifth branch and pre-opening expenses of our sixth branch.

Income Tax Expense. Income tax expense was $1,589,224 for the nine months ended September 30, 2006, compared to income tax expense of $1,676,716 for the nine months ended September 30, 2005. The reduction in income tax expense was due to the $187,509 decrease in income before income taxes in the 2006 period. Our effective tax rate remained the same for the periods ended September 30, 2006 and 2005 at 46.6%.

VSB Bancorp, Inc.
Consolidated Average Balance Sh
(unaudited)

	Three Months Ended September 30, 2006			
	Average Balance	Interest	Yield/ Cost	Average Balance
Assets:				
Interest-earning assets:				
Loans receivable	$ 69,220,537	$ 1,794,879	10.19%	$ 74,314,
Investment securities, afs	116,174,628	1,336,087	4.56	110,601,
Other interest-earning assets	22,297,337	282,049	5.02	20,636,
Total interest-earning assets	207,692,502	3,413,015	6.49	205,552,
Non-interest earning assets	13,956,539			13,034,
Total assets	$221,649,041			$218,586,
Liabilities and equity:				
Interest-bearing liabilities:				
Savings accounts	$ 13,372,021	23,607	0.70	$ 16,605,
Time accounts	75,616,485	662,769	3.48	62,123,
Money market accounts	18,211,593	85,246	1.86	19,599,
Now accounts	22,036,471	27,867	0.50	26,224,
Short Term Borrowings	76,087	1,112	5.80	
Subordinated debt	5,155,000	89,040	6.91	5,155,
Total interest-bearing liabilities	134,467,657	889,641	2.62	129,706,
Checking accounts	68,859,364			71,722,
Total deposits and subordinated debt	203,327,021			201,429,
Other liabilities	2,452,036			2,659,
Total liabilities	205,779,057			204,089,
Equity	15,869,984			14,497,
Total liabilities and equity	$221,649,041			$218,586,
Net interest income/net interest rate spread		$ 2,523,374	3.87%	

Net interest earning assets/net interest margin	$ 73,224,845		4.79%	$ 75,845,
Ratio of interest-earning assets to interest-bearing liabilities	1.54x			1
Return on Average Assets (1)	1.14%			1
Return on Average Equity (1)	15.87%			18
Tangible Equity to Total Assets	7.45%			6

	Nine Months Ended September 30, 2006			
	Average Balance	Interest	Yield/ Cost	Average Balance
Assets:				
Interest-earning assets:				
Loans receivable	$ 71,136,492	$ 5,301,788	9.91%	$ 70,499,
Investment securities, afs	113,578,686	3,862,518	4.55	117,561,
Other interest-earning assets	17,183,553	594,676	4.63	14,814,
Total interest-earning assets	201,898,731	9,758,982	6.44	202,876,
Non-interest earning assets	14,067,821			12,967,
Total assets	$215,966,552			$215,843,
Liabilities and equity:				
Interest-bearing liabilities:				
Savings accounts	$ 13,679,963	62,985	0.62	$ 15,768,
Time accounts	69,745,174	1,647,723	3.16	57,234,
Money market accounts	19,631,360	264,909	1.80	21,229,
Now accounts	21,470,419	77,512	0.48	24,602,
Short Term Borrowings	25,641	1,112	5.80	
Subordinated debt	5,155,000	267,119	6.91	5,155,
Total interest-bearing liabilities	129,707,557	2,321,360	2.39	123,990,
Checking accounts	68,457,394			75,572,
Total deposits and subordinated debt	198,164,951			199,563,
Other liabilities	2,458,242			2,494,
Total liabilities	200,623,193			202,058,
Equity	15,343,359			13,785,
Total liabilities and equity	$215,966,552			$215,843,
Net interest income/net interest rate spread		$ 7,437,622	4.05%	

Net interest earning assets/net interest margin	$ 72,191,174	4.91%	$ 78,885,
Ratio of interest-earning assets to interest-bearing liabilities	1.56x		1
Return on Average Assets (1)	1.12%		1
Return on Average Equity (1)	15.75%		18
Tangible Equity to Total Assets	7.45%		6

(1) Ratios have been annualized.

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Liquidity and Capital Resources

Our primary sources of funds are increases in deposits and proceeds from the repayment of investment securities. We use these funds principally to purchase new investment securities and to fund new and renewing loans in our loan portfolio.

During the nine months ended September 30, 2006, our retail banking activities generated a net increase in deposits of $4,140,330 and we had a net decrease in loans receivable of $8,081,181, which combined to generate $12,221,511 in cash. In addition, we received proceeds from repayment of investment securities of $16,031,264. We used $23,944,173 of available funds to purchase new investment securities, resulting in an overall increase in cash and cash equivalents of $4,730,238. We applied available funds principally to purchase the $23,944,173 of investment securities to increase investment collateral available to pledge for the $20 million in municipal CDs that we received in the second quarter of 2006 in connection with our opening of our Rosebank branch.

In contrast, during the nine months ended September 30, 2005, we had a net decrease in deposits of $10,230,968 and proceeds from repayment of investment securities totaled $23,066,398. We used the resulting net increase in funds primarily to finance $8,075,805 in new and renewing loans, with substantially all of the remainder being used to fund an increase in overnight investments and other short-term interest-earning assets.

The Bank satisfied all capital ratio requirements of the Federal Deposit Insurance Corporation at September 30, 2006, with a Tier I Leverage Capital ratio of 10.13%, a ratio of Tier I Capital to Risk-Weighted Assets ratio of 23.28%, and a Total Capital to Risk-Weighted Assets ratio of 24.52%.

VSB Bancorp, Inc. satisfied all capital ratio requirements of the Federal Reserve at September 30, 2006, with a Tier I Leverage Capital ratio of 10.48%, a ratio of Tier I Capital to Risk-Weighted Assets ratio of 24.04%, and a Total Capital to Risk-Weighted Assets ratio of 25.27%.

In the first nine months of 2006, we experienced a $4,730,238 increase in cash and cash equivalents compared to a $6,770,535 decrease in cash and cash

equivalents during the first nine months of 2005. Total cash and cash equivalents at September 30, 2006 were $36,054,385. One of the important tasks facing management in upcoming periods is to seek appropriate opportunities to invest such liquid assets into higher yielding assets such as loans and investment securities.

The following table sets forth our contractual obligations and commitments for future lease payments, time deposit maturities and loan commitments.

Contractual Obligations and Commitments at September 30, 2006

Contractual Obligations	Payment due by Period			
	Less than One Year	One to three years	Four to five years	After five yea
Minimum annual rental payments under non-cancelable operating leases	$ 420,960	$ 791,034	$ 814,209	$ 2,741,
Remaining contractual maturities of time deposits	41,499,223	29,048,702	1,078,841	2,063,
Total contractual cash obligations	$ 41,920,183	$ 29,839,736	$ 1,893,050	$ 4,805,

Other commitments	Amount of commitment Expiration by Pe			
	Less than One Year	One to three years	Four to five years	After five yea
Loan commitments	$ 19,959,700	$ 5,181,260	$ 200,000	$

Our loan commitments shown in the above table represent both commitments to make new loans and obligations to make additional advances on existing loans, such as construction loans in process and lines of credit. Substantially all of these commitments involve loans with fluctuating interest rates, so the outstanding commitments do not expose us to interest rate risk upon fluctuation in market rates. We consider the amount of outstanding commitments when we assess our allowance for loan losses.

Critical Accounting Policies and Judgments

We are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting period. The allowance for loan losses, prepayment estimates on the mortgage-backed securities and Collateralized Mortgage Obligation portfolios, contingencies and fair values of

financial instruments are particularly subject to change and to management's estimates. Actual results can differ from those estimates and may have an impact on our financial statements.

Item 3 - Controls and Procedures

Evaluation of Disclosure Controls and Procedures: As of September 30, 2006, we undertook an evaluation of our disclosure controls and procedures under the supervision and with the participation of Merton Corn, President and CEO, and Raffaele M. Branca, Executive Vice President and CFO. Disclosure controls are the systems and procedures we use that are designed to ensure that information we are required to disclose in the reports we file or submit under the Securities Exchange Act of 1934 (such as annual reports on Form 10-KSB and quarterly periodic reports on Form 10-QSB) is recorded, processed, summarized and reported, in a manner which will allow senior management to make timely decisions on the public disclosure of that information. Messrs. Corn and Branca concluded that our current disclosure controls and procedures are effective in ensuring that such information is (i) collected and communicated to senior management in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Since our last evaluation of our disclosure controls, we have not made any significant changes in, or corrective actions taken regarding, either our internal controls or other factors that could significantly affect those controls.

We intend to continually review and evaluate the design and effectiveness of our disclosure controls and procedures and to correct any deficiencies that we may discover. Our goal is to ensure that senior management has timely access to all material financial and non-financial information concerning our business so that they can evaluate that information and make determinations as to the nature and timing of disclosure of that information.

While we believe the present design of our disclosure controls and procedures is effective to achieve this goal, future events may cause us to modify our disclosure controls and procedures.

Part II

Item 1 - Legal Proceedings

The Bank is a defendant in an action pending in Supreme Court, Richmond County, commenced by IndyMac Bank, F.S.B. against the Bank, LaMattina & Associates, Inc. ("LAI") and various individuals and entities alleged to be officers, directors or otherwise to have relationships with LAI. LAI was a deposit customer of the Bank engaged in the business of providing real estate settlement services to lenders making residential mortgage loans. The plaintiff alleges that it was such a lender and that it had provided funds to LAI by wiring those funds to an account of LAI at the Bank to use to fund mortgage loans to be made by the plaintiff, only to have LAI not use those funds for their intended purpose. The action was commenced in August 2005. In November 2005, the plaintiff amended its complaint to add the Bank as a defendant. The Plaintiff has served a third amended complaint asserting claims against the Bank based upon alleged negligence, misappropriation and deceptive business practices under the New York General Business Law and requesting monetary damages against the Bank of $1,817,041 plus recovery of attorney's fees. The Bank intends to defend aggressively the amended claims and has made a motion to dismiss the third amended complaint. Oral argument on the motion is scheduled for November 2006, after which the motion will be submitted to the court for a decision. The Bank

has referred the litigation to its insurance carrier, which has indicated that at least some of the claims are covered by insurance.

Signature Page

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

VSB Bancorp, Inc.

Date: November 14, 2006

/s/ MERTON CORN

Merton Corn
President and Chief Executive Officer

Date: November 14, 2006

/s/ RAFFAELE M. BRANCA

Raffaele M. Branca
Executive Vice President and Chief Financial Officer

EXHIBIT INDEX

Exhibit Number	Description of Exhibit
31.1	Rule 13A-14(a)/15D-14(a) Certification of Chief Executive Officer
31.2	Rule 13A-14(a)/15D-14(a) Certification of Chief Financial Officer
32.1	Certification by CEO pursuant to 18 U.S.C. 1350.
32.2	Certification by CFO pursuant to 18 U.S.C. 1350.

Item 6 - Exhibits

Exhibit Number	Description of Exhibit
31.1	Rule 13A-14(a)/15D-14(a) Certification of Chief Executive Officer
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