FAUQUIER BANKSHARES, INC.
Form 10-Q
August 09, 2010

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

(Mark One)

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2010

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from __________ to __________

Commission File No.: 000-25805
Fauquier Bankshares, Inc.
(Exact name of registrant as specified in its charter)

Virginia	**54-1288193**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
10 Courthouse Square, Warrenton, Virginia	**20186**
(Address of principal executive offices)	(Zip Code)

(540) 347-2700
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)
Yes o No þ

The registrant had 3,636,758 shares of common stock outstanding as of August 5, 2010.

FAUQUIER BANKSHARES, INC.
INDEX

	Page
Part I. FINANCIAL INFORMATION	
Item 1. Financial Statements	3
Consolidated Balance Sheets as of June 30, 2010 (unaudited) and December 31, 2009	3
Consolidated Statements of Income (unaudited) for the Three Months Ended June 30, 2010 and 2009	4
Consolidated Statements of Income (unaudited) for the Six Months Ended June 30, 2010 and 2009	5
Consolidated Statements of Changes in Shareholders Equity (unaudited) for the Six Months Ended June 30, 2010 and 2009	6
Consolidated Statements of Cash Flows (unaudited) for the Six Months Ended June 30, 2010 and 2009	7
Notes to Consolidated Financial Statements	8
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	23
Item 3. Quantitative and Qualitative Disclosures About Market Risk	40
Item 4. Controls and Procedures	40
Part II. OTHER INFORMATION	
Item 1. Legal Proceedings	40
Item 1A. Risk Factors	41
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	41
Item 3. Defaults Upon Senior Securities	41
Item 4. Removed and Reserved	41
Item 5. Other Information	41
Item 6. Exhibits	41
SIGNATURES	42
EX-3.2	
EX-31.1	
EX-31.2	
EX-32.1	
EX-32.2	

Table of Contents

Part I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Balance Sheets

	June 30, 2010 (Unaudited)	December 31, 2009 (Audited)
Assets		
Cash and due from banks	$ 5,427,162	$ 5,652,617
Interest-bearing deposits in other banks	33,308,994	20,546,596
Federal funds sold	7,763	9,154
Securities available for sale	41,571,312	36,692,094
Restricted investments	3,774,700	3,774,700
Loans, net of allowance for loan losses of $5,397,291 in 2010 and $5,481,963 in 2009	462,730,068	462,783,962
Bank premises and equipment, net	14,521,091	14,025,745
Accrued interest receivable	1,493,861	1,495,085
Other real estate owned, net of valuation allowance	2,412,085	2,479,860
Other assets	21,109,497	21,022,655
Total assets	$ 586,356,533	$ 568,482,468
Liabilities and Shareholders Equity		
Deposits:		
Noninterest-bearing	67,182,415	68,469,699
Interest-bearing:		
NOW accounts	108,356,203	83,395,687
Savings and money market accounts	118,721,836	106,458,563
Time certificates of deposit	198,565,203	207,662,808
Total interest-bearing	425,643,242	397,517,058
Total deposits	492,825,657	465,986,757
Federal funds purchased		
Federal Home Loan Bank advances	40,000,000	50,000,000
Company-obligated mandatorily redeemable capital securities	4,124,000	4,124,000
Other liabilities	5,532,892	5,732,869
Commitments and contingencies		
Total liabilities	542,482,549	525,843,626
Shareholders Equity		
Common stock, par value, $3.13; authorized 8,000,000 shares: issued and outstanding, 2010: 3,635,758 shares (includes nonvested shares of 33,772); 2009: 3,594,685 shares (includes nonvested shares of 47,282)	11,274,216	11,103,371

Retained earnings	34,140,810	33,458,933
Accumulated other comprehensive income (loss), net	(1,541,042)	(1,923,462)
Total shareholders equity	43,873,984	42,638,842
Total liabilities and shareholders equity	$ 586,356,533	$ 568,482,468

See accompanying Notes to Consolidated Financial Statements.

3

Table of Contents

Fauquier Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income
(Unaudited)
For the Three Months Ended June 30, 2010 and 2009

	2010	2009
Interest Income		
Interest and fees on loans	$ 6,722,975	$ 6,465,313
Interest and dividends on securities available for sale:		
Taxable interest income	302,606	315,979
Interest income exempt from federal income taxes	56,542	57,925
Dividends	6,651	15,765
Interest on federal funds sold	8	49
Interest on deposits in other banks	15,990	3,309
Total interest income	7,104,772	6,858,340
Interest Expense		
Interest on deposits	1,337,008	1,441,683
Interest on federal funds purchased	36	12,400
Interest on Federal Home Loan Bank advances	192,161	229,694
Distribution on capital securities of subsidiary trusts	20,503	29,385
Total interest expense	1,549,708	1,713,162
Net interest income	5,555,064	5,145,178
Provision for loan losses	375,000	360,000
Net interest income after provision for loan losses	5,180,064	4,785,178
Other Income		
Wealth management income	355,838	247,808
Service charges on deposit accounts	645,489	719,444
Other service charges, commissions and income	515,939	432,890
(Loss) on sale or impairment of other real estate owned	(45,000)	
(Loss) on sale of investments	(1,689)	
Net other than temporary impairment losses on securities		(166,388)
Total other income	1,470,577	1,233,754
Other Expenses		
Salaries and benefits	2,802,936	2,328,120

Net occupancy expense of premises	443,404	318,242
Furniture and equipment	291,122	268,831
Marketing expense	164,444	187,299
Legal, audit and consulting expense	294,721	476,961
Federal Deposit Insurance Corporation expense	170,462	385,050
Data processing expense	378,891	333,511
Other operating expenses	738,588	725,224
Total other expenses	5,284,568	5,023,238
Income before income taxes	1,366,073	995,694
Income tax expense	355,501	272,013
Net Income	$ 1,010,572	$ 723,681
Earnings per Share, basic	$ 0.28	$ 0.20
Earnings per Share, assuming dilution	$ 0.28	$ 0.20
Dividends per Share	$ 0.20	$ 0.20

See accompanying Notes to Consolidated Financial Statements.

Table of Contents

Fauquier Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income
(Unaudited)
For the Six Months Ended June 30, 2010 and 2009

	2010	2009
Interest Income		
Interest and fees on loans	$ 13,414,252	$ 12,846,384
Interest and dividends on securities available for sale:		
Taxable interest income	605,261	672,142
Interest income exempt from federal income taxes	115,977	119,386
Dividends	13,467	20,228
Interest on federal funds sold	11	156
Interest on deposits in other banks	24,078	6,978
Total interest income	14,173,046	13,665,274
Interest Expense		
Interest on deposits	2,612,032	2,999,773
Interest on federal funds purchased	36	22,846
Interest on Federal Home Loan Bank advances	465,781	496,361
Distribution on capital securities of subsidiary trusts	39,828	65,220
Total interest expense	3,117,677	3,584,200
Net interest income	11,055,369	10,081,074
Provision for loan losses	750,000	560,000
Net interest income after provision for loan losses	10,305,369	9,521,074
Other Income		
Wealth management income	662,407	497,044
Service charges on deposit accounts	1,266,941	1,326,120
Other service charges, commissions and income	942,271	836,270
(Loss) on sale or impairment of other real estate owned	(61,139)	(135,759)
Gain on sale of investments	87,418	
Net other than temporary impairment losses on securities recognized in earnings (includes total other than temporary impairment losses of $276,278, net of $199,395 gain recognized in other comprehensive income for the six months ended June 30, 2010 before tax benefit)	(475,673)	(166,388)
Total other income	2,422,225	2,357,287

Other Expenses		
Salaries and benefits	5,250,624	4,685,610
Net occupancy expense of premises	943,306	625,309
Furniture and equipment	608,818	549,281
Marketing expense	320,862	308,358
Legal, audit and consulting expense	561,952	812,904
Federal Deposit Insurance Corporation expense	353,079	530,100
Data processing expense	736,996	691,389
Other operating expenses	1,537,918	1,415,252
Total other expenses	10,313,555	9,618,203
Income before income taxes	2,414,039	2,260,158
Income tax expense	599,574	613,568
Net Income	$ 1,814,465	$ 1,646,590
Earnings per Share, basic	$ 0.50	$ 0.46
Earnings per Share, assuming dilution	$ 0.50	$ 0.46
Dividends per Share	$ 0.40	$ 0.40

See accompanying Notes to Consolidated Financial Statements.

Table of Contents

Fauquier Bankshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders Equity
For the Six Months Ended June 30, 2010 and 2009

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
Balance, December 31, 2008	$ 11,036,687	$ 32,668,530	$ (2,217,280)		$ 41,487,937
Comprehensive income:					
Net income		1,646,590		1,646,590	1,646,590
Other comprehensive income net of tax:					
Unrealized holding losses on securities available for sale, net of tax benefit of $334,949				(650,195)	
Add: reclassification adjustments for other than temporary impairment, net of tax of $56,572				109,816	
Other comprehensive income net of tax of $278,377			(540,379)	(540,379)	(540,379)
Total comprehensive income				1,106,211	
Cash dividends ($.40 per share)		(1,438,615)			(1,438,615)
Amortization of unearned compensation, restricted stock awards		152,063			152,063
Issuance of common stock nonvested shares (10,585 shares)	33,131	(33,131)			
Exercise of stock options	27,293	54,487			81,780
Balance, June 30, 2009	$ 11,097,111	$ 33,049,924	$ (2,757,659)		$ 41,389,376
Balance, December 31, 2009	$ 11,103,371	$ 33,458,933	$ (1,923,462)		$ 42,638,842
Comprehensive income:					
Net income		1,814,465		$ 1,814,465	1,814,465
Other comprehensive income net of tax:					
Unrealized holding gains on securities available for sale, net of tax of $64,998			126,172	126,172	126,172

Less: gain on sale of securities available for sale, net net of tax benefit of $29,722			(57,696)	(57,696)	(57,696)
Add: reclassification adjustments for other than temporary impairment, net of tax of $161,729			313,944	313,944	313,944
Other comprehensive income net of tax of $197,005				382,420	
Total comprehensive income				2,196,885	
Cash dividends ($.40 per share)		(1,451,260)			(1,451,260)
Amortization of unearned compensation, restricted stock awards		243,554			243,554
Issuance of common stock nonvested shares (28,847 shares)	90,291	(90,291)			
Issuance of common stock vested shares (6,522 shares)	20,414	69,459			89,873
Exercise of stock options	60,140	95,950			156,090
Balance, June 30, 2010	$ 11,274,216	$ 34,140,810	$ (1,541,042)		$ 43,873,984

See accompanying Notes to Consolidated Financial Statements.

Table of Contents

Fauquier Bankshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2010 and 2009
(Unaudited)

	2010	2009
Cash Flows from Operating Activities		
Net income	$ 1,814,465	$ 1,646,590
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	622,495	404,070
Provision for loan losses	750,000	560,000
Loss on impairment of other real estate	45,000	
Loss on sale of other real estate	16,139	135,759
(Gain) on sale of securities	(87,418)	
Loss on impairment of securities	475,673	166,388
Amortization (accretion) of security premiums, net	26,018	(20,186)
Amortization of unearned compensation, net of forfeiture	243,554	152,063
Changes in assets and liabilities:		
(Increase) in other assets	(282,624)	(275,387)
(Decrease) increase in other liabilities	(199,976)	585,683
Net cash provided by operating activities	3,423,326	3,354,980
Cash Flows from Investing Activities		
Proceeds from sale of securities available for sale	1,541,751	
Proceeds from maturities, calls and principal payments of securities available for sale	5,255,068	4,804,868
Purchase of securities available for sale	(11,510,884)	(3,596,504)
Purchase of premises and equipment	(1,117,841)	(2,789,227)
Purchase proceeds from sale of other bank stock		(719,900)
Net (increase) in loans	(1,124,106)	(18,013,946)
Proceeds from sale of other real estate owned	434,636	869,626
Net cash used in investing activities	(6,521,376)	(19,445,083)
Cash Flows from Financing Activities		
Net increase (decrease) in demand deposits, NOW accounts and savings accounts	35,936,505	(4,250,078)
Net (decrease) increase in certificates of deposit	(9,097,606)	16,557,098
Federal Home Loan Bank advances		150,000,000
Federal Home Loan Bank principal repayments	(10,000,000)	(150,000,000)
Purchase of federal funds		3,525,000
Cash dividends paid on common stock	(1,451,260)	(1,438,615)
Issuance of common stock	245,963	81,780

Net cash provided by financing activities		15,633,602		14,475,185
Increase (decrease) in cash and cash equivalents		12,535,552		(1,614,918)
Cash and Cash Equivalents				
Beginning		26,208,367		11,023,162
Ending	$	38,743,919	$	9,408,244
Supplemental Disclosures of Cash Flow Information				
Cash payments for:				
Interest	$	3,144,161	$	3,726,758
Income taxes	$	1,024,000	$	635,000
Supplemental Disclosures of Noncash Investing Activities				
Unrealized gain (loss) on securities available for sale, net of tax effect	$	382,420	$	(540,379)
Other real estate acquired in settlement of loans	$	428,000	$	

See accompanying Notes to Consolidated Financial Statements.

FAUQUIER BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

Note 1. General

The consolidated statements include the accounts of Fauquier Bankshares, Inc. (the Company) and its wholly-owned subsidiaries: The Fauquier Bank (the Bank) and Fauquier Statutory Trust II; and the Bank s wholly-owned subsidiary, Fauquier Bank Services, Inc. In consolidation, significant intercompany financial balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial positions as of June 30, 2010 and December 31, 2009 and the results of operations for the three and six months ended June 30, 2010 and 2009. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s 2009 Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC).

The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of the results expected for the full year.

Recent Accounting Pronouncements

In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The new disclosure guidance will significantly expand the existing requirements and will lead to greater transparency into a company s exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period will become effective for both interim and annual reporting periods ending after December 15, 2010. Specific items regarding activity that occurred before the issuance of the ASU, such as the allowance roll-forward and modification disclosures, will be required for periods beginning after December 15, 2010. The Company is currently assessing the impact that ASU 2010-20 will have on its consolidated financial statements.

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as SFAS No. 166, Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140 , was adopted into Codification in December 2009 through the issuance of Accounting Standards Updated (ASU) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor s continuing involvement, if any, in transferred financial assets. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In June 2009, the FASB issued new guidance relating to the variable interest entities. The new guidance, which was issued as SFAS No. 167, Amendments to FASB Interpretation No. 46(R), was adopted into Codification in December 2009. The objective of the guidance is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167 is effective as of January 1, 2010. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In October 2009, the FASB issued Accounting Standards Update No. 2009-15 (ASU 2009-15), Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing. ASU 2009-15 amends Subtopic 470-20 to expand accounting and reporting guidance for own-share lending arrangements issued in contemplation of convertible debt issuance. ASU 2009-15 is effective for fiscal years beginning on or after December 15, 2009 and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In January 2010, the FASB issued ASU 2010-04, *Accounting for Various Topics Technical Corrections to SEC Paragraphs*. ASU 2010-04 makes technical corrections to existing SEC guidance including the following

topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In February 2010, the FASB issued Accounting Standards Update No. 2010-08, Technical Corrections to Various Topics. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements. ASU 2010-09 addresses both the interaction of the requirements of Topic 855 with the SEC s reporting requirements and the intended breadth of the reissuance disclosures provisions related to subsequent events. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. ASU 2010-09 is effective immediately. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

Note 2. Securities

The amortized cost and fair value of securities available for sale, with unrealized gains and losses follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
	June 30, 2010			
Obligations of U.S. Government corporations and agencies	$ 32,708,867	$ 1,214,897	$	$ 33,923,764
Obligations of states and political subdivisions	5,468,100	214,747	(3,723)	5,679,124
Corporate Bonds	4,865,613		(3,229,435)	1,636,178
Mutual Funds	321,419	4,827		326,246
FHLMC Preferred Bank Stock	18,500		(12,500)	6,000
	$ 43,382,499	$ 1,434,471	$ (3,245,658)	$ 41,571,312

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
	December 31, 2009			
Obligations of U.S. Government corporations and agencies	$ 27,837,619	$ 916,798	$ (25,592)	$ 28,728,825
Obligations of states and political subdivisions	5,569,586	163,021	(8,758)	5,723,849
Corporate Bonds	5,341,286		(3,428,830)	1,912,456

Mutual Funds	315,715		(3,451)	312,264
FHLMC Preferred Bank Stock	18,500		(3,800)	14,700
	$ 39,082,706	$ 1,079,819	$ (3,470,431)	$ 36,692,094

The amortized cost and fair value of securities available for sale, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations without penalties.

Table of Contents

	June 30, 2010	
	Amortized Cost	Fair Value
Due in one year or less	$	$
Due after one year through five years	4,109,304	4,118,968
Due after five years through ten years	8,993,687	9,457,520
Due after ten years	29,939,589	27,662,578
Equity securities	339,919	332,246
	$ 43,382,499	$ 41,571,312

There were no impairment losses on securities in the quarter ended June 30, 2010 and $166,000 of impairment losses in the quarter ended June 30, 2009. For the six months ended June 30, 2010 and 2009, impairment losses on securities were $476,000 and $166,000, respectively.

There were no securities sold in the quarters ended June 30, 2010 and 2009. The loss of $2,000 recognized during the June 2010 quarter reflected a final accounting adjustment of a bond sold on March 31, 2010. During the six months ended June 30, 2010, one security, a 30 year mortgage-backed government agency with a fair value of $1.5 million, was sold on March 31, 2010 at a gain of $87,000. This bond was sold because of its relatively longer term current duration of approximately five years, and its inherent extension risk of an additional two years of duration if market interest rates increase in the future. The tax expense on this gain on sale was $30,000. There were no securities sold in the six months ended June 30, 2009.

The following table shows the Company securities with gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2010 and December 31, 2009, respectively.

June 30, 2010	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
Obligations of U.S. Government corporations and agencies	$	$	$	$	$	$
Obligations of states and political subdivisions			280,374	(3,723)	280,374	(3,723)
Corporate bonds			1,636,178	(3,229,435)	1,636,178	(3,229,435)
Subtotal, debt securities			1,916,552	(3,233,158)	1,916,552	(3,233,158)
Mutual funds						
FHLMC preferred bank stock			6,000	(12,500)	6,000	(12,500)
Total temporary impaired securities	$	$	$ 1,922,552	$ (3,245,658)	$ 1,922,552	$ (3,245,658)

December 31, 2009	Less than 12 Months		12 Months or More		Total	
		Unrealized		Unrealized		Unrealized

Description of Securities	Fair Value	(Losses)	Fair Value	(Losses)	Fair Value	(Losses)
Obligations of U.S. Government corporations and agencies	$ 3,030,782	$ (25,592)	$	$	$ 3,030,782	$ (25,592)
Obligations of states and political subdivisions	312,667	(174)	275,475	(8,584)	588,142	(8,758)
Corporate bonds			1,912,456	(3,428,830)	1,912,456	(3,428,830)
Subtotal, debt securities	3,343,449	(25,766)	2,187,931	(3,437,414)	5,531,380	(3,463,180)
Mutual funds			312,263	(3,451)	312,263	(3,451)
FHLMC preferred bank stock	14,700	(3,800)			14,700	(3,800)
Total temporary impaired securities	$ 3,358,149	$ (29,566)	$ 2,500,194	$ (3,440,865)	$ 5,858,343	$ (3,470,431)

Table of Contents

The nature of securities which are temporarily impaired for a continuous 12 month period or more at June 30, 2010 can be segregated into three groups:

The first group consists of four corporate bonds with a cost basis totaling $4.9 million and a temporary loss of approximately $3.2 million. The method for valuing these four corporate bonds came from Moody s Analytics. Moody s Analytics employs a two step discounted cash-flow valuation process. The first step is to use Monte Carlo simulations to evaluate the credit quality of the collateral pool and the structural supports. Step two is to apply a discount rate to the cash flows to calculate a value. These four corporate bonds are the Class B or subordinated mezzanine tranche of pooled trust preferred securities. Each of the four trust preferred securities are collateralized by the interest and principal payments made on trust preferred capital offerings by a geographically diversified pool of approximately 60 different financial institutions. They have an estimated maturity of approximately 24 years. These bonds could have been called at par on the five year anniversary date of issuance, which has already passed for all four bonds. The bonds reprice every three months at a fixed rate index above the three-month London Interbank Offered Rate (LIBOR). These bonds have sufficient collateralization and cash flow projections to satisfy their valuation based on the cash flow portion of the other than temporary impairment (OTTI) test under authoritative accounting guidance as of June 30, 2010. All four bonds totaling $1.6 million at fair value, are greater than 90 days past due, and are classified as nonperforming corporate bond investments in the nonperforming asset table in Note 4.

Additional information regarding each of the pooled trust preferred securities as of June 30, 2010 follows:

Cost, net of OTTI loss	Fair Value	Percent of Underlying Current Collateral Performing	Percent of Underlying Collateral in Deferral	Percent of Underlying Collateral in Default	Estimated incremental defaults required to break yield (1)	Current Moody s Rating	Cumulative Amount of OTTI Loss	Cumulative Other Compreshensive Loss, net of tax benefit
$ 359,294	$ 38,376	55.7%	29.5%	14.8%	broken	Ca	$ 640,706	$ 211,806
1,822,050	730,097	76.3%	11.7%	12.0%	broken	Ca	177,950	720,689
1,899,350	690,878	77.1%	18.1%	4.8%	broken	Ca	100,650	797,592
784,919	176,827	73.4%	14.6%	12.0%	broken	Ca	215,081	401,341
$ 4,865,613	$ 1,636,178						$ 1,134,387	$ 2,131,428

(1) A break in yield for a given tranche investment means that defaults and/or deferrals have reached such a level that the specific tranche would not receive all of the contractual

principal and interest cash flow by its maturity, resulting in not a temporary shortfall, but an actual loss.

The Company monitors these pooled trust preferred securities in its portfolio as to additional collateral issuer defaults and deferrals, which as a general rule indicate that additional impairment may have occurred. Due to the continued stress on banks in general, and the issuer banks in particular, as a result of overall economic conditions, the Company anticipates having to recognize additional impairment in future periods; however the extent, timing, and probability of any additional impairment cannot be reasonably estimated at this time.

The second group consists of one municipal bond with a temporary loss of approximately $4,000. This bond is current, and the Company plans to hold it until maturity in 2020.

The third group consists of Federal Home Loan Mortgage Corporation preferred bank stock with a temporary loss of $13,000. It represents a relatively small balance of the portfolio and the Company plans to hold it indefinitely.

Table of Contents

The following roll forward reflects the amount related to credit losses recognized in earnings (in accordance with FASB Accounting Standards Codification (ASC) 320-10-35-34D):

	Available for sale
Beginning balance as of December 31, 2009	$ 658,714
Add: Amount related to the credit loss for which an other-than- temporary impairment was not previously recognized	100,650
Add: Increases to the amount related to the credit loss for which an other-than temporary impairment was previously recognized	375,023
Less: Realized losses for securities sold	
Less: Securities for which the amount previously recognized in other comprehensive income was recognized in earnings because the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis	
Less: Increases in cash flows expected to be collected that are recognized over the remaining life of the security (See FASB ASC 320-10-35-35)	
Ending balance as of June 30, 2010	$ 1,134,387

The carrying value of securities pledged to secure deposits and for other purposes amounted to $28.9 million and $23.7 million at June 30, 2010 and December 31, 2009, respectively.
The amortized cost and fair value of restricted securities follows:

	June 30, 2010			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized (Losses)**	**Fair Value**
Restricted investments:				
Federal Home Loan Bank Stock	$ 3,625,700	$	$	$ 3,625,700
Federal Reserve Bank Stock	99,000			99,000
Community Bankers Bank Stock	50,000			50,000
	$ 3,774,700	$	$	$ 3,774,700

	December 31, 2009			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized (Losses)**	**Fair Value**
Restricted investments:				
Federal Home Loan Bank Stock	$ 3,625,700	$	$	$ 3,625,700
Federal Reserve Bank Stock	99,000			99,000
Community Bankers Bank Stock	50,000			50,000
	$ 3,774,700	$	$	$ 3,774,700

The Company s restricted investments include an equity investment in the Federal Home Loan Bank of Atlanta (FHLB). FHLB stock is generally viewed as a long term investment and as a restricted investment which is carried at cost because there is no market for the stock other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on ultimate recoverability of the par value rather than recognizing temporary declines in value. Despite the FHLB s temporary suspension of cash dividends during 2009, the Company does not consider this investment to be other than temporarily impaired at June 30, 2010, and no impairment has been recognized.

Table of Contents

Note 3. Loans
A summary of the balances of loans follows:

	June 30, 2010	December 31, 2009
	(Thousands)	
Real estate loans:		
Construction	$ 35,834	$ 33,003
Secured by farmland	1,090	948
Secured by 1 - to - 4 family residential	191,258	193,709
Other real estate loans	189,249	186,463
Commercial and industrial loans (not secured by real estate)	28,253	29,286
Consumer installment loans	8,350	10,390
All other loans	14,331	14,559
Total loans	$ 468,365	$ 468,358
Unearned income	(238)	(92)
Allowance for loan losses	(5,397)	(5,482)
Net loans	$ 462,730	$ 462,784

Of the $189.2 million in other real estate loans at June 30, 2010, $97.9 million or 51.7% were owner occupied. Of the $186.5 million in other real estate loans at December 31, 2009, $100.3 million or 53.8% were owner occupied.

Note 4. Allowance for Loan Losses
Analysis of the allowance for loan losses follows:

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009	Twelve Months Ended December 31, 2009
Balance at beginning of year	$ 5,481,963	$ 4,779,662	$ 4,779,662
Provision for loan losses	750,000	560,000	1,710,000
Recoveries of loans previously charged-off	66,056	45,203	81,106
Loan losses charged-off	(900,728)	(294,028)	(1,088,805)
Balance at end of year	$ 5,397,291	$ 5,090,837	$ 5,481,963

Nonperforming assets consist of the following:

(Dollars in thousands)	June 30, 2010	December 31, 2009	June 30, 2009
Non-accrual loans	$ 2,479	$ 3,410	$ 1,139
Restructured loans			

Other real estate owned	2,412	2,480	2,029
Other repossessed assets owned	11	54	51
Non-performing corporate bond investments, at fair value	1,636	1,126	
Total nonperforming assets	$ 6,538	$ 7,070	$ 3,219
Allowance for loan losses to total loans, period end	1.15%	1.17%	1.11%
Non-accrual loans to total loans, period end	0.53%	0.73%	0.25%
Allowance for loan losses to non-accrual loans, period end	217.71%	160.76%	446.96%
Non-performing assets to total assets, period end	1.12%	1.24%	0.61%

	June 30, 2010	December 31, 2009	June 30, 2009
Impaired loans for which an allowance has been provided	$ 2,579,891	$ 3,213,516	$ 2,080,567
Impaired loans for which no allowance has been provided	509,475	175,429	180,361
	$ 3,089,366	$ 3,388,945	$ 2,260,928
Allowance provided for impaired loans, included in the allowance for loan losses	$ 1,008,100	$ 1,163,072	$ 1,080,071

	Six Months Ended June 30, 2010	Twelve Months Ended December 31, 2009	Six Months Ended June 30, 2009
Average balance in impaired loans	$ 3,171,924	$ 3,631,937	$ 2,278,436
Interest income recognized on impaired loans	$ 36,032	$ 148,490	$ 42,231

There were no loans past due 90 days or more and still accruing interest at June 30, 2010, and $354,000 and $780,000 past due 90 days or more and still accruing interest on December 31, 2009, and June 30, 2009, respectively.
Authoritative accounting guidance requires that the impairment of loans that have been separately identified for evaluation is to be measured based on the present value of expected future cash flows or, alternatively, the observable market price of the loans or the fair value of the collateral. However, for those loans that are collateral dependent (that is, if repayment of those loans is expected to be provided solely by the underlying collateral) and for which management has determined foreclosure is probable, the measure of impairment is to be based on the net realizable value of the collateral. Authoritative accounting guidance also requires certain disclosures about investments in impaired loans and the allowance for loan losses and interest income recognized on loans.
A loan is considered impaired when it is probable that the Bank will be unable to collect all principal and interest amounts according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, expected future cash flows, financial condition of the borrower, and the current economic conditions. A performing loan may be considered impaired if the factors above indicate a need for impairment. A loan on non-accrual status may not be impaired if it is in the process of collection or if the shortfall in payment is insignificant. A delay of less than 30 days or a shortfall of less than 5% of the required principal and interest payments generally is considered insignificant and would not indicate an impairment situation, if, in management s judgment, the loan will be paid in full. Loans that meet the regulatory definitions of doubtful or loss generally qualify as impaired loans under authoritative accounting guidance. As is the case for all loans, charge-offs for impaired loans occur when the loan or portion of the loan is determined to be uncollectible.

Note 5. Company-Obligated Mandatorily Redeemable Capital Securities

On September 21, 2006, the Company s wholly-owned Connecticut statutory business trust privately issued $4 million face amount of the trust s Floating Rate Capital Securities in a pooled capital securities offering (Trust II). Simultaneously, the trust used the proceeds of that sale to purchase $4.0 million principal amount of the Company s Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. The interest rate on the capital security

resets every three months at 1.70% above the then current three month LIBOR. Interest is paid quarterly.
Total capital securities at June 30, 2010 and December 31, 2009 were $4,124,000 for both respective dates. The Trust II issuance of capital securities and the respective subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

Table of Contents

On July 1, 2010, the Company entered into a 10-year, $4 million cash-flow swap whereby the Company pays 3.21% and receives the three month LIBOR rate. The LIBOR rate resets every three months on the same day that the capital security resets. The net effect of this transaction is that it converts the capital security from having a rate that fluctuates every three months as described above, into a capital security that has a fixed rate of 4.91% through September 2020.

Note 6. Earnings Per Share

The following table shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of dilutive potential common stock. Dilutive potential common stock had no effect on income available to common shareholders.

	Three Months Ended June 30, 2010		Three Months Ended June 30, 2009	
	Shares	**Per Share Amount**	**Shares**	**Per Share Amount**
Basic earnings per share	3,631,411	$ 0.28	3,596,537	$ 0.20
Effect of dilutive securities, stock-based awards	16,943		9,992	
	3,648,354	$ 0.28	3,606,529	$ 0.20

	Six Months Ended June 30, 2010		Six Months Ended June 30, 2009	
	Shares	**Per Share Amount**	**Shares**	**Per Share Amount**
Basic earnings per share	3,617,173	$ 0.50	3,588,845	$ 0.46
Effect of dilutive securities, stock-based awards	17,549		7,324	
	3,634,722	$ 0.50	3,596,169	$ 0.46

All shares in circulation were dilutive and included in the calculation above at June 30, 2010. Shares not included in the calculation above because their effects were not dilutive totaled 23,732 at June 30, 2009.

Note 7. Stock-Based Compensation

Stock Incentive Plan (2009)

On May 19, 2009, the shareholders of the Company approved the Company s Stock Incentive Plan (the Plan), which superseded and replaced the Omnibus Stock Ownership and Long-Term Incentive Plan.

Under the Plan, stock options, stock appreciation rights, non-vested and/or restricted shares, and long-term performance unit awards may be granted to directors and employees for purchase of the Company s stock. The effective date of the Plan is March 19, 2009, the date the Company s Board approved the Plan, and the Plan has a termination date of December 31, 2019. The Company s Board may terminate, suspend or modify the Plan within

certain restrictions. The Plan authorizes for issuance 350,000 shares of the Company s common stock. The Plan requires that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant. Such options are generally not exercisable until three years from the date of issuance and generally require continuous employment during the period prior to exercise. The options will expire in no more than ten years after the date of grant. The stock options, stock appreciation rights, restricted shares, and long-term performance unit awards for employees are generally subject to vesting requirements and are subject to forfeiture if vesting and other contractual provision requirements are not met. The restricted shares for non-executive directors are not subject to vesting requirements, but are generally subject to three year restrictions of sale.

The Company did not grant stock options during the six months ended June 30, 2010 or June 30, 2009. The

Table of Contents

Company previously has issued stock options to non-employee directors and employees under its Omnibus Stock Ownership and Long-Term Incentive Plan.
A summary of the status of the options granted under the above described plans is presented below:

	Six Months Ended June 30, 2010		
	Number of Shares	Weighted Average Exercise Price	Average Intrinsic Value (1)
Outstanding at January 1, 2010	62,480	$ 9.96	
Granted			
Exercised	(19,214)	8.12	
Forfeited			
Outstanding at June 30, 2010	43,266	$ 10.77	
Exercisable at end of quarter	43,266		$ 204,035
Weighted-average fair value per option of options granted during the year			

(1) The aggregate intrinsic value of stock options in the table above reflects the pre-tax intrinsic value (the amount by which the June 30, 2010 market value of the underlying stock option exceeded the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on June 30, 2010. This amount

changes based on the changes in the market value of the Company s stock.

The total intrinsic value of options exercised during the six months ended June 30, 2010 and 2009 was $153,851 and $22,478, respectively.

The Company has granted awards of shares to executive officers and non-employee directors under the above-described incentive plans: 9,784 shares and 15,050 shares of non-vested restricted stock to executive officers and 5,553 shares and 8,450 shares of vested restricted stock to non-executive directors on March 5, 2010 and February 18, 2009, respectively.

The restricted shares are accounted for using the fair market value of the Company s common stock on the date the restricted shares were awarded. The restricted shares issued to executive officers are subject to a vesting period, whereby, the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded. Compensation expense for non-vested shares amounted to $38,294 and $66,774, net of forfeiture, for the three months ended June 30, 2010 and 2009, respectively. Compensation expense for non-vested shares amounted to $243,554 and $152,063, net of forfeiture, for the six months ended June 30, 2010 and 2009, respectively. During the quarter ended March 31, 2010, the restricted shares previously issued to non-employee directors were no longer subject to a vesting period, and the previously deferred compensation expense on these shares, totaling an additional compensation expense of approximately $150,000, was fully recognized during the first quarter of 2010.

A summary of the status of the Company s non-vested restricted shares granted under the above described plans is presented below:

	Six Months Ended June 30, 2010	
	Number of Shares	Weighted Average Price
Non-vested at January 1, 2010	47,282	
Granted	15,337	$ 13.78
Vested	(28,847)	
Non-vested at June 30, 2010	33,772	

Table of Contents

As of June 30, 2010, there was $227,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over an approximate period of 32 months.

The performance-based stock rights are accounted for using the fair market value of the Company s common stock on the date the restricted shares were awarded, and adjusted as the market value of the stock changes. The performance-based stock rights shares issued to executive officers are subject to a vesting period, whereby, the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded. They are also subject to the Company reaching a predetermined return on average equity ratio for the final year of the vesting period. Compensation expense for performance-based stock rights amounted to $39,961 and $26,693 during the three months ended June 30, 2010 and 2009, respectively. Compensation expense for performance-based stock rights amounted to $67,794 and $38,879 during the six months ended June 30, 2010 and 2009, respectively.

Note 8. Employee Benefit Plan

The following table provides a reconciliation of the changes in the defined benefit pension plan s obligations for the three and six months ended June 30, 2010 and 2009.

	Three Months Ended June 30,	
	2010	**2009**
Service cost	$	$ 62,707
Interest cost	79,523	73,827
Expected return on plan assets	(64,176)	(65,839)
Amortization of transition (asset)		
Amortization of prior service cost		
Recognized net actuarial (gain) loss	186,613	
Net periodic benefit cost	$ 201,960	$ 70,695

	Six Months Ended June 30,	
	2010	**2009**
Service cost	$	$ 125,414
Interest cost	159,046	147,654
Expected return on plan assets	(128,352)	(130,868)
Amortization of transition (asset)		
Amortization of prior service cost		
Recognized net actuarial (gain) loss	186,613	
Net periodic benefit cost	$ 217,307	$ 142,200

On December 20, 2007, the Company s Board of Directors approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010, the Company replaced the defined benefit pension plan with an enhanced 401(k) plan. On January 18, 2009, the assets within the defined benefit pension plan were redeployed from ownership in various equity and debt mutual fund investments, and into a short-term money market fund in order to preserve asset value until the plan terminated and is distributed.

The Company previously disclosed in its financial statements for the year ended December 31, 2009, that there were no contributions made to its pension plan in 2009. Based on the March 31, 2010 value of assets of $6,376,033 and an estimated liability of approximately $6,889,000 projected as of September 1, 2010, the Company estimates that an additional contribution of approximately $500,000 will be required to fund the plan termination settlement.

Approximately $200,000 of this additional contribution has been accrued and expensed in the quarter ended June 30, 2010, and the remaining $300,000 will be accrued and expensed during the quarter ended September 30, 2010. Defined benefit pension plan expenses are projected to be approximately $500,000 in 2010 and zero in 2011 and thereafter due to the curtailment. Expenses for the 401(k) plan were $150,000 and $300,000 for the three and six month periods ended June 30, 2010, respectively. Expenses for the 401(k) plan are projected to be

Table of Contents

approximately $625,000 in 2010. Growth in 401(k) after 2010 is projected to increase approximately at the same rate of increase as salaries.

Note 9. Fair Value Measurement

The Company adopted ASC 820 Fair Value Measurement and Disclosures (previously SFAS No. 157, Fair Value Measurements), on January 1, 2008 to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. ASC 820 clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

ASC 820 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s market assumptions. The three levels of the fair value hierarchy under ASC 820 based on these two types of inputs are as follows:

Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2).

Table of Contents

The following table presents the balances of financial assets and liabilities carried at fair value on a recurring basis as of June 30, 2010 and December 31, 2009 by levels within the valuation hierarchy:

(In Thousands) Description	Balance	Fair Value Measurements at Using Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at June 30, 2010				
Available-for-sale securities:				
Obligations of U.S. Government corporations and agencies	$ 33,924	$	$ 33,924	$
Obligations of states and political subdivisions	5,679		5,679	
Corporate bonds	1,636			1,636
Mutual funds	326		326	
FHLMC Preferred	6		6	
Total available-for-sale securities	$ 41,571		$ 39,935	$ 1,636
Assets at December 31, 2009				
Available-for-sale securities:				
Obligations of U.S. Government corporations and agencies	$ 28,729	$	$ 28,729	$
Obligations of states and political subdivisions	5,724		5,724	
Corporate bonds	1,912			1,912
Mutual funds	312		312	
FHLMC Preferred	15		15	
Total available-for-sale securities	$ 36,692		$ 34,780	$ 1,912

Change in Level 3 Fair Value

The changes in Level 3 assets measured at estimated fair value on a recurring basis during the quarter ended June 30, 2010 were as follows:

(In Thousands) Description	Balance January 1, 2010	Total Gains (Losses) Realized/Unrealized Included in earnings	Included in Other Comprehensive Income	Transfers in and/or out of Level 3	Balance June 30, 2010
Assets at June 30, 2010					
Available-for-sale securities:					
Corporate bonds	$ 1,912	$ (476)	$ (276)	$ 476	$ 1,636

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain financial assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans held for sale: Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the quarter ended June 30, 2010. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

Table of Contents

Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. Certain assets such as real estate owned are measured at fair value less the estimated cost to sell. Management believes that the fair value component in its valuation follows the provisions of ASC 820.

The following table summarizes the Company s financial assets that were measured at fair value on a nonrecurring basis during the period.

		Carrying value at June 30, 2010		
(In Thousands) **Description**	**Balance as of June 30, 2010**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:				
Impaired loans, net	$ 1,572		$ 1,457	$ 115
Other real estate owned	2,412		2,412	

		Carrying value at December 31, 2009		
(In Thousands) **Description**	**Balance as of December 31, 2009**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:				

Impaired loans, net	$ 2,050	$ 794	$ 1,256
Other real estate owned	2,480	2,480	

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instruments. ASC 820 (previously SFAS No. 107 Disclosures about Fair Value of Financial Instruments) excludes certain financial instruments and all non-financial instruments from its

disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and cash equivalents

The carrying amounts of cash and short-term instruments approximate fair value.

Securities

For securities and marketable equity securities held for investment purposes, fair values are based on quoted market prices or dealer quotes. For other securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair values are based on quoted market prices for similar securities. See Note 2 Securities of the Notes to Consolidated Financial Statements for further discussion on determining fair value for pooled trust preferred securities.

Loan Receivables

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (e.g., one-to-four family residential), credit card loans, and other consumer loans are based on quoted market prices of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics. Fair values for other loans (i.e., commercial real estate and investment property mortgage loans, commercial and industrial loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Deposit Liabilities

The fair values disclosed for demand deposits (i.e., interest and non-interest bearing checking, statement savings and money market accounts) are, by definition, equal to the amount payable at the reporting date (that is, their carrying amounts). Fair values of fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered to a schedule of aggregated expected monthly maturities on time deposits.

Federal Funds Purchased

The carrying amounts of the Company s federal funds purchased are approximate fair value.

Federal Home Loan Bank Advances

The fair values of the Company s FHLB advances are estimated using discounted cash flow analyses based on the Company s current incremental borrowing rates for similar types of borrowing arrangements.

Off-Balance-Sheet Financial Instruments

The fair value of commitments to extend credit is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present credit worthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates.

The fair value of standby letters of credit is based on fees currently charged for similar

Table of Contents

agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

At June 30, 2010 and 2009, the fair value of loan commitments and standby letters of credit were deemed immaterial.

The estimated fair values of the Company s financial instruments are as follows:

	June 30, 2010		December 31, 2009	
(In Thousands)	**Carrying Amount**	**Fair Value**	**Carrying Amount**	**Fair Value**
Financial assets:				
Cash and short-term investments	$ 38,736	$ 38,736	$ 26,199	$ 26,199
Federal funds sold	8	8	9	9
Securities	41,571	41,571	36,692	36,692
Restricted securities	3,775	3,775	3,775	3,775
Loans, net	462,730	484,347	462,784	477,100
Accrued interest receivable	1,494	1,494	1,495	1,495
Financial liabilities:				
Deposits	$ 492,826	$ 483,878	$ 465,987	$ 467,600
FHLB advances	40,000	41,296	50,000	50,477
Federal funds purchased				
Company obligated mandatorily redeemable capital securities	4,124	2,973	4,124	2,673

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Company s financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Company s overall interest rate risk.

Note 10. Subsequent Events

In accordance with ASC 855-10/SFAS 165, the Company evaluates subsequent events that have occurred after the balance sheet date, but before the financial statements are issued. There are two types of subsequent events: (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) non-recognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

The Company evaluated subsequent events through the date of filing this document. Based on the evaluation, the Company did not identify any recognized or non-recognized subsequent events that would have required adjustment to, or disclosure in, the financial statements.

Table of Contents

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

In addition to the historical information contained herein, this report contains forward-looking statements. Forward-looking statements are based on certain assumptions and describe future plans, strategies, and expectations of the Company and the Bank, and are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, project may, will or similar expressions. Although we believe our plans, intentions and expectations reflected in these forward-looking statements are reasonable, we can give no assurance that these plans, intentions, or expectations will be achieved. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain, and actual results could differ materially from those contemplated. Factors that could have a material adverse effect on our operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, the legislative/regulatory climate, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Board of Governors of the Federal Reserve System, the quality or composition of the Bank s loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area, our plans to expand our branch network and increase our market share, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements in this report and you should not place undue reliance on such statements, which reflect our position as of the date of this report.

For additional discussion of risk factors that may cause our actual future results to differ materially from the results indicated within forward-looking statements, please see Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

GENERAL

Fauquier Bankshares, Inc. (the Company) was incorporated under the laws of the Commonwealth of Virginia on January 13, 1984. The Company is a registered bank holding company and owns all of the voting shares of The Fauquier Bank (the Bank). The Company engages in its business through the Bank, a Virginia state-chartered bank that commenced operations in 1902. The Company has no significant operations other than owning the stock of the Bank. The Company had issued and outstanding 3,635,758 shares of common stock, par value $3.13 per share, held by approximately 419 holders of record on June 30, 2010. The Bank has ten full service branch offices located in the Virginia communities of Old Town-Warrenton, Warrenton, Catlett, The Plains, Sudley Road-Manassas, Old Town-Manassas, New Baltimore, Bealeton, Bristow and Haymarket. The executive offices of the Company and the main office of the Bank are located at 10 Courthouse Square, Warrenton, Virginia 20186.

The Bank s general market area principally includes Fauquier County, western Prince William County, and neighboring communities and is located approximately fifty (50) miles southwest of Washington, D.C.

The Bank provides a range of consumer and commercial banking services to individuals, businesses and industries. The deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation (FDIC). The basic services offered by the Bank include: non-interest-bearing demand deposit accounts, money market deposit accounts, NOW accounts, time deposits, safe deposit services, credit cards, cash management, direct deposits, notary services, night depository, prepaid debit cards, cashier s checks, domestic collections, savings bonds, automated teller services, drive-in tellers, internet banking, telephone banking, and banking by mail. In addition, the Bank makes secured and unsecured commercial and real estate loans, issues stand-by letters of credit and grants available credit for installment, unsecured and secured personal loans, residential mortgages and home equity loans, as well as automobile and other types of consumer financing. The Bank provides automated teller machine (ATM) cards, as a part of the Cirrus, Accel-Exchange and Plus ATM networks, thereby permitting customers to utilize the convenience of larger ATM networks. The Bank also is a member of the Certificate of Deposit Account Registry Service (CDARS). CDARs can provide a customer multi-million dollar FDIC insurance on CD investments through the transfer and/or exchange with other FDIC insured institutions. CDARS is a registered service mark of Promontory Interfinancial Network, LLC.

The Bank operates a Wealth Management Services (WMS or Wealth Management) division that began with the granting of trust powers to the Bank in 1919. The WMS division provides personalized services that include investment management, trust, estate settlement, retirement, insurance, and brokerage services.

The Bank, through its subsidiary Fauquier Bank Services, Inc., has equity ownership interests in Bankers Insurance, LLC, a Virginia independent insurance company; Infinex Investments, Inc., a full service broker/dealer; and Bankers Title Shenandoah, LLC, a title insurance company. Bankers Insurance consists of a consortium of Virginia community bank owners; Infinex is owned by banks and banking associations in various states; and Bankers Title Shenandoah is owned by a consortium of Virginia community banks.

The revenues of the Bank are primarily derived from interest on, and fees received in connection with, real estate and other loans, and from interest and dividends from investment and mortgage-backed securities, and short-term investments. The principal sources of funds for the Bank s lending activities are its deposits, repayment of loans, the sale and maturity of investment securities, and borrowings from the Federal Home Loan Bank (FHLB) of Atlanta. Additional revenues are derived from fees for deposit-related and WMS-related services. The Bank s principal expenses are the interest paid on deposits and operating and general administrative expenses.

As is the case with banking institutions generally, the Bank s operations are materially and significantly influenced by general economic conditions and by related monetary and fiscal policies of financial institution regulatory agencies, including the Board of Governors of the Federal Reserve System (Federal Reserve). As a Virginia-chartered bank and a member of the Federal Reserve, the Bank is supervised and examined by the Federal Reserve and the Virginia State Corporation Commission. Interest rates on competing investments and general market rates of interest influence deposit flows and costs of funds. Lending activities are affected by the demand for financing of real estate and other types of loans, which in turn is affected by the interest rates at which such financing may be offered and other factors affecting local demand and availability of funds. The Bank faces strong competition in the attraction of deposits (its primary source of lendable funds) and in the origination of loans. Please see Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

As of June 30, 2010, the Company had total consolidated assets of $586.4 million, total loans net of allowance for loan losses of $462.7 million, total consolidated deposits of $492.8 million, and total consolidated shareholders equity of $43.9 million.

CRITICAL ACCOUNTING POLICIES

GENERAL. The Company s financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, 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 either when earning income, recognizing an expense, recovering an asset or relieving a liability. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use in our estimates. In addition, GAAP itself may change from one previously acceptable accounting method to another method. Although the economics of the Company s transactions would be the same, the timing of events that would impact the Company s transactions could change.

ALLOWANCE FOR LOAN LOSSES. The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on three basic principles of accounting: (i) Accounting Standards Codification (ASC) 450 Contingencies (previously Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies) which requires that losses be accrued when they are probable of occurring and estimable, (ii) ASC 310 Receivables (previously SFAS No. 114, Accounting by Creditors for Impairment of a Loan) which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance and (iii) Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues, which requires adequate documentation to support the allowance for loan losses estimate.

The Company s allowance for loan losses has two basic components: the specific allowance and the general allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance for larger balance, non-homogeneous loans. The specific allowance uses various techniques to arrive at an estimate of loss. First, analysis of the borrower s overall financial condition, resources and payment record, the prospects for support from financial guarantors, and the fair market value of collateral are used to estimate the probability and severity of inherent losses. Then the migration of historical default rates and loss severities, internal risk ratings, industry and market conditions and trends, and other environmental factors are considered. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The general allowance is used for estimating the loss on pools of smaller-balance, homogeneous loans; including 1-4 family mortgage loans, installment loans, other consumer loans, and outstanding loan commitments. Also, the general allowance is used for the remaining pool of larger balance, non-homogeneous loans which were not allocated a specific allowance upon their review. The general allowance begins with estimates of probable losses inherent in the homogeneous portfolio based upon various statistical analyses. These include analysis of historical and peer group delinquency and credit loss experience, together with analyses that reflect current trends and conditions. The Company also considers trends and changes in the volume and term of loans, changes in the credit process and/or lending policies and procedures, and an evaluation of overall credit quality. The general allowance uses a historical loss view as an indicator of future losses. As a result, even though this history is regularly updated with the most recent loss information, it could differ from the loss incurred in the future. The general allowance also captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in the specific allowances.

Specifically, the Company uses both external and internal qualitative factors when determining the non-loan-specific allowances. The external factors utilized include: unemployment in the Company s defined market area of Fauquier County, Prince William County, and the City of Manassas (market area), as well as state and national unemployment trends; new residential construction permits for the market area; bankruptcy statistics for the Virginia Eastern District and trends for the United States; and foreclosure statistics for the market area and the state. Quarterly, these external qualitative factors as well as relevant anecdotal information are evaluated from data compiled from local periodicals such as *The Washington Post, The Fauquier Times Democrat*, and *The Bull Run Observer*, which cover the Company s market area. Additionally, data is gathered from the *Federal Reserve Beige Book for the Richmond Federal Reserve District*, *Global Insight* s monthly economic review, the George Mason School of Public Policy Center for Regional Analysis, and daily economic updates from various other sources. Internal Bank data utilized includes: loans past due aging statistics, nonperforming loan trends, trends in collateral values, loan concentrations, loan review status downgrade trends, and lender turnover and experience trends. Both external and internal data is analyzed on a rolling six quarter basis to determine risk profiles for each qualitative factor. Ratings are assigned through a defined matrix to calculate the allowance consistent with authoritative accounting literature. A narrative summary of the reserve allowance is produced quarterly and reported directly to the Company s Board of Directors. The Company s application of these qualitative factors to the allowance for loan losses has been consistent over the reporting period.

The Company employs an independent outsourced loan review function, which annually substantiates and/or adjusts internally generated risk ratings and loan impairment calculations. This independent review is reported directly to the Company s Board of Directors audit committee, and the results of this review are factored into the calculation of the allowance for loan losses.

EXECUTIVE OVERVIEW

This discussion is intended to focus on certain financial information regarding the Company and the Bank and may not contain all the information that is important to the reader. The purpose of this discussion is to provide the reader with a more thorough understanding of our financial statements. As such, this discussion should be read carefully in conjunction with the consolidated financial statements and accompanying notes contained elsewhere in this report.

The Bank is the primary independent community bank in its immediate market area as measured by deposit market share. It seeks to be the primary financial service provider for its market area by providing the right mix of consistently high quality customer service, efficient technological support, value-added products, and a strong

commitment to the community. The Company and the Bank s primary operating businesses are in commercial and retail lending, deposit accounts and core deposits, and assets under WMS management.

Net income of $1.01 million for the second quarter of 2010 was a 39.6% increase from the net income for the second quarter of 2009 of $724,000. Loans, net of reserve, totaling $462.7 million at June 30, 2010, decreased less than 0.1% when compared with December 31, 2009, and increased 2.3% when compared with June 30, 2009. Deposits, totaling $492.8 million at June 30, 2010, increased 5.8% compared with year-end 2009, and increased 19.4% when compared with June 30, 2009. Assets under WMS management, totaling $292.7 million in market value at June 30, 2010, increased 4.8% from $279.3 million in market value at June 30, 2009.

Net interest income is the largest component of net income, and equals the difference between income generated on interest-earning assets and interest expense incurred on interest-bearing liabilities. Future trends regarding net interest income are dependent on the absolute level of market interest rates, the shape of the yield curve, the amount of lost income from non-performing assets, the amount of prepaying loans, the mix and amount of various deposit types, competition for loans and deposits, and many other factors, as well as the overall volume of interest-earning assets. These factors are individually difficult to predict, and when taken together, the uncertainty of future trends compounds. Based on management s current projections, net interest income may continue to increase in the last half of 2010 and beyond as average interest-earning assets increase, but this may be offset in part or in whole by a possible contraction in the Bank s net interest margin resulting from competitive market conditions and/or a flat or inverted yield curve. A steeper yield curve is projected to result in an increase in net interest income, while a flatter or inverted yield curve is projected to result in a decrease in net interest income.

The Bank s non-performing assets totaled $6.5 million or 1.12% of total assets at June 30, 2010, as compared with $7.1 million or 1.24% of total assets at December 31, 2009, and $3.2 million or 0.61% of total assets at June 30, 2009. Nonaccrual loans totaled $2.5 million or 0.53% of total loans at June 30, 2010 compared with $3.4 million or 0.73% of total loans at December 31, 2009, and $1.1 million or 0.25% of total loans at June 30, 2009. The provision for loan losses was $750,000 for the first six months of 2010 compared with $560,000 for the first six months of 2009. Loan charge-offs, net of recoveries, totaled $835,000 or 0.18% of total average loans for the first six months of 2010, compared with $249,000 or 0.06% of total average loans for the first six months of 2009. The $190,000 increase in the provision for loan losses for the first six months of 2010 compared with the first six months of 2009 was largely in response to the increase in loan charge-offs, partially offset by the decline in nonaccrual loans since December 2009. Total allowance for loan losses was $5.4 million or 1.15% of total loans at June 30, 2010 compared with $5.5 million or 1.17% of loans at December 31, 2009 and $5.1 million or 1.11% of loans at June 30, 2009.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2010 AND JUNE 30, 2009

NET INCOME

Net income of $1.01 million for the second quarter of 2010 was a 39.6% increase from the net income for the second quarter of 2009 of $724,000. Earnings per share on a fully diluted basis were $0.28 for the second quarter of 2010 compared with $0.20 for the second quarter of 2009. Profitability as measured by return on average assets increased from 0.55% in the second quarter of 2009 to 0.69% for the same period in 2010. Profitability as measured by return on average equity increased from 7.02% to 9.28% over the same respective quarters in 2009 and 2010. The increase in net income and the corresponding profitability measures was primarily due to the $410,000 increase in net interest income in the second quarter of 2010 compared with the second quarter of 2009, as well as a $215,000 decrease in FDIC expense.

NET INTEREST INCOME AND EXPENSE

Net interest income increased $410,000 or 8.0% to $5.56 million for the quarter ended June 30, 2010 from $5.15 million for the quarter ended June 30, 2009. The increase in net interest income was due to the impact of total average earning assets increasing $56.3 million or 11.5% from $490.4 million during the second quarter of 2009 to $546.7 million during the second quarter of 2010. This was partially offset by the Company s net interest margin decreasing from 4.23% in the second quarter of 2009 to 4.10% in the second quarter of 2010.

Total interest income increased $246,000 or 3.6% to $7.10 million for the second quarter of 2010 from $6.86 million for the second quarter of 2009. This increase was primarily due to the increase in total average earning assets of $56.3 million from second quarter 2009 to second quarter 2010.

The average yield on loans was 5.75% for the second quarter of 2010 compared with 5.76% for the second quarter of 2009. Average loan balances increased $19.8 million or 4.4% from $449.3 million during the second quarter of 2009 to $469.1 million during the second quarter of 2010. The increase in loans outstanding and constant yield resulted in a $258,000 or 4.0% increase in interest and fee income from loans for the second quarter of 2010 compared with the same period in 2009.

Average investment security balances increased $7.7 million from $34.6 million in the second quarter of 2009 to $42.3 million in the second quarter of 2010. The tax-equivalent average yield on investments decreased from 4.82% for the second quarter of 2009 to 3.74% for the second quarter of 2010. Together, there was a decrease in interest and dividend income on security investments of $24,000 or 6.1%, from $390,000 for the second quarter of 2009 to $366,000 for the second quarter of 2010. This decrease was partially due to the suspension of interest payments on the Bank s investment in pooled trust-preferred corporate bonds during 2010. Interest income on deposits in other banks increased $13,000 from second quarter 2009 to second quarter 2010.

Total interest expense decreased $163,000 or 9.5% from $1.71 million for the second quarter of 2009 to $1.55 million for the second quarter of 2010 primarily due to the overall decline in shorter-term market interest rates, as well as an $85,000 gain on the early repayment of a FHLB of Atlanta advance. Interest paid on deposits decreased $105,000 or 7.3% from $1.44 million for the second quarter of 2009 to $1.34 million for the second quarter of 2010. Average NOW deposit balances increased $29.2 million from the second quarter of 2009 to the second quarter of 2010, while the average rate on NOW accounts increased from 0.40% to 0.69%, resulting in an increase of $107,000 in NOW interest expense for the second quarter of 2010. Average money market account balances decreased $6.3 million from second quarter 2009 to second quarter 2010, while their average rate decreased from 0.79% to 0.75% over the same period, resulting in a decrease of $18,000 of interest expense for the second quarter of 2010. Average savings account balances increased $15.6 million from the second quarter of 2009 to the second quarter of 2010 while the average rate on savings deposits increased from 0.27% to 0.47%, resulting in a increase of $35,000 in interest expense for the second quarter of 2010. Average time deposit balances increased $29.2 million from the second quarter of 2009 to the second quarter of 2010 while the average rate on time deposits decreased from 2.86% to 1.97%, resulting in a decrease of $228,000 in interest expense for the second quarter of 2010.

Interest expense on FHLB of Atlanta advances decreased $38,000 from the second quarter of 2009 to the second quarter of 2010 due to an $85,000 gain on the early repayment of a FHLB advance, partially offset by an increase in the average interest rate. During the June 2010 quarter, the Bank chose to repay a $10.0 million advance in order to reduce its excess liquidity, and to better structure the balance sheet for the possibility of future increases in short-term interest rates. Without this one-time gain, the average rate paid on FHLB advances would have increased from 1.61% for the June 2009 quarter to 2.38% for the June 2010 quarter. Instead, with this one-time gain, the rate paid on FHLB advances declined to 1.65% for the June 2010 quarter. For the last nine months, the Bank has been strategically extending the weighted average maturity of its FHLB advances in order to reduce its exposure to rising interest rates. The average rate on total interest-bearing liabilities decreased from 1.65% for the second quarter of 2009 to 1.32% for the second quarter of 2010.

The following table sets forth information relating to the Company s average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated and the average yields and rates paid for the periods indicated. These yields and costs are derived by dividing income or expense by the average daily balances of assets and liabilities, respectively, for the periods presented.

AVERAGE BALANCES, INCOME AND EXPENSES, AND AVERAGE YIELDS AND RATES
(Dollars in Thousands)

	Three Months Ended June 30, 2010			Three Months Ended June 30, 2009		
	Average Balances	Income/ Expense	Average Rate	Average Balances	Income/ Expense	Average Rate
ASSETS:						
Loans						
Taxable	$ 451,954	$ 6,561	5.75%	$ 439,302	$ 6,390	5.76%
Tax-exempt (1)	14,032	246	6.93%	8,450	146	6.84%
Nonaccrual (2)	3,099			1,574		
Total Loans	469,085	6,807	5.75%	449,326	6,536	5.76%
Securities						
Taxable	36,626	309	3.38%	29,187	329	4.51%
Tax-exempt (1)	5,631	86	6.09%	5,365	88	6.54%
Total securities	42,257	395	3.74%	34,552	417	4.82%
Deposits in banks	35,388	16	0.18%	6,397	3	0.20%
Federal funds sold	8		0.38%	75		0.25%
Total earning assets	546,738	7,218	5.23%	490,350	6,956	5.62%
Less: Reserve for loan losses	(5,526)			(5,013)		
Cash and due from banks	6,317			6,823		
Bank premises and equipment, net	14,536			9,685		
Other real estate owned	2,354			2,029		
Other assets	22,211			19,604		
Total Assets	$ 586,630			$ 523,478		
LIABILITIES & SHAREHOLDERS EQUITY:						
Deposits						
Demand deposits	$ 68,406			$ 63,575		
Interest-bearing deposits						
NOW accounts	106,912	185	0.69%	77,702	78	0.40%
Money market accounts	64,082	120	0.75%	70,406	138	0.79%

Savings accounts	50,160	59	0.47%	34,579	24	0.27%
Time deposits	197,742	973	1.97%	168,509	1,201	2.86%
Total interest-bearing deposits	418,896	1,337	1.28%	351,196	1,441	1.65%
Federal funds purchased	55		0.26%	3,900	12	1.28%
Federal Home Loan Bank advances	46,044	192	1.65%	56,464	230	1.61%
Capital securities of subsidiary trust	4,124	21	1.97%	4,124	29	2.82%
Total interest-bearing liabilities	469,119	1,550	1.32%	415,684	1,712	1.65%
Other liabilities	5,442			2,875		
Shareholders equity	43,663			41,344		
Total Liabilities & Shareholders Equity	$ 586,630			$ 523,478		
Net interest spread		$ 5,668	3.91%		$ 5,244	3.98%
Interest expense as a percent of average earning assets			1.13%			1.40%
Net interest margin			4.10%			4.23%

(1) Income and rates on non-taxable assets are computed on a tax equivalent basis using a federal tax rate of 34%.

(2) Nonaccrual loans are included in the average balance of total loans and total earning assets.

Normally, the shrinkage of the net interest margin from 4.23% for the quarter ended June 30, 2009 to 4.10% for the quarter ended June 30, 2010 would be of concern to the Bank. However, in the case of the quarter ended June 30,

2010, the rapid growth in deposits, and the lack of lending opportunities being immediately available, led to a temporary balance sheet mismatch of approximately $17.5 million in excess liquidity. These funds were temporarily invested in low yielding deposits at other banks at a weighted average interest rate of 0.18% and will be used to repay $2.5 million of brokered deposits and $15 million of FHLB advances with a total weighted average interest rate of 0.84% in July 2010. This repositioning of the balance sheet will increase net interest income by $29,000 for the quarter ended September 30, 2010. In addition, net interest income was positively impacted by a one-time gain on the prepayment of a $10 million FHLB advance during the quarter ended June 30, 2010. All other things remaining unchanged, the repositioning of the balance sheet and the absence of the one-time gain on the FHLB advance prepayment is expected to increase the net interest margin by 15 basis points for the quarter ending September 2010 and restore the net interest margin to 4.25% which is more consistent with the net interest margin of 4.27% reported for the quarter ended March 31, 2010.

	Average Balance	Net interest income	Average Rate
Total Earning Assets and Margin	$ 546,738	$ 5,668	4.10%
Plus: Excess brokered deposits and FHLB advances		37	0.84%
Less: Incremental Deposits at other banks	(17,500)	(8)	0.18%
Subtotal	529,238	5,697	4.32%
Less: Gain on early repayment of FHLB advance		(85)	
Adjusted Earning Assets and Margin	$ 529,238	$ 5,612	4.25%

RATE/VOLUME ANALYSIS

The following table sets forth certain information regarding changes in interest income and interest expense of the Company for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to changes in volume (change in volume multiplied by old rate); and changes in rates (change in rate multiplied by old volume). Changes in rate-volume, which cannot be separately identified, are allocated proportionately between changes in rate and changes in volume.

RATE / VOLUME VARIANCE
(In Thousands)
Three Months Ended June 30, 2010
Compared to Three Months Ended June 30, 2009

	Change	**Due to Volume**	**Due to Rate**
INTEREST INCOME			
Loans; taxable	$ 171	$ 184	(13)
Loans; tax-exempt (1)	100	96	4
Securities; taxable	(20)	84	(104)
Securities; tax-exempt (1)	(2)	4	(6)
Deposits in banks	13	14	(1)
Federal funds sold			
Total Interest Income	262	382	(120)
INTEREST EXPENSE			
NOW accounts	107	29	78
Money market accounts	(18)	(12)	(6)
Savings accounts	35	11	24
Time deposits	(228)	208	(436)
	(12)	(12)	

Federal funds purchased and securities sold under agreements to repurchase			
Federal Home Loan Bank advances	(38)	(42)	4
Capital securities of subsidiary trust	(8)		(8)
Total Interest Expense	(162)	182	(344)
Net Interest Income	$ 424	$ 200	$ 224

(1) Income and rates on non-taxable assets are computed on a tax equivalent basis using a federal tax rate of 34%.

PROVISION FOR LOAN LOSSES, ALLOWANCE FOR LOAN LOSSES, AND ASSET QUALITY

The provision for loan losses was $375,000 for the second quarter of 2010, compared with $360,000 for the second quarter of 2009. The amount of the provision for loan loss was based upon management s continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank s delinquent and non-performing loans, estimated values of collateral, and the impact of

economic conditions on borrowers. Greater weight is given to the loss history by loan category, prolonged changes in portfolio delinquency trends by loan category, and changes in economic trends. There can be no assurances, however, that future losses will not exceed estimated amounts, or that increased amounts of provisions for loan losses will not be required in future periods.

OTHER INCOME

Total other income increased by $237,000 from $1.23 million for the second quarter of 2009 to $1.47 million in the second quarter of 2010. Non-interest income is derived primarily from recurring non-interest fee income, which consists primarily of fiduciary and other Wealth Management fees, service charges on deposit accounts, and other fee income. The increase in other income was primarily due to the absence of a loss on the impairment of the Bank s investment in pooled trust preferred corporate bonds during the quarter ended June 30, 2010, compared with a $166,000 loss one year earlier. Additionally, there was a $108,000 increase in Wealth Management income.

Wealth Management income increased $108,000 or 43.6% from the second quarter of 2009 to the second quarter of 2010, as assets under management increased from year to year, primarily due to the increase in overall stock market valuations as well as the growth in new customer relationships and brokerage revenues.

Service charges on deposit accounts decreased $74,000 or 10.3% to $645,000 for the second quarter of 2010 compared to one year earlier. Due to changes in regulations regarding customer usage of overdraft protection services, service charges on deposit accounts are projected to decline during the second half of 2010. Whether this is a temporary change to customer preferences for overdraft protection, or a more permanent structural change, is difficult to determine at this point in time.

Other service charges, commissions and fees increased $83,000 or 19.2% from $433,000 in second quarter of 2009 to $516,000 in second quarter of 2010 primarily due to increased electric funds transfer interchange income on Bank debit cards. Also included in other service charges, commissions, and income is Bank Owned Life Insurance (BOLI) income, which was $103,000 during the second quarter of 2010 compared with $101,000 one year earlier. Total BOLI was $11.0 million at June 30, 2010, compared with $10.6 million one year earlier.

OTHER EXPENSE

Total other expense increased $261,000 or 5.2% during the second quarter of 2010 compared with the second quarter of 2009. Salaries and employees benefits increased $475,000 or 20.4%, partially due to a $242,000 increase in retirement benefits. This increase is the result of the termination of the Bank s defined-benefit pension plan and enhancement of its defined-contribution 401(k) plan. For additional information regarding retirement benefits, see Employee Benefit Plan in Note 8 of the Notes to Consolidated Financial Statements contained herein. Additionally, salary and other benefit expenses increased due to the impact of staffing the Bristow and Haymarket offices in 2010 that was largely absent in 2009. Active full-time equivalent personnel totaled 164 at June 30, 2010 compared with 156 at June 30, 2009. The June 2009 data includes seven full-time equivalent positions that were then recently hired and being trained to staff the Bristow branch office that opened in July 2009. The increase in full-time equivalent personnel was primarily due to the staffing of the Haymarket office since the second quarter of 2009.

The Company s Board of Directors approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010 the Board approved to replace the defined benefit pension plan with an enhanced 401(k) plan. Defined benefit pension plan expenses are projected to be approximately $500,000 in 2010, and zero in 2011 and thereafter, due to the termination of the defined benefit plan. Expenses for the 401(k) plan are projected to increase to approximately $625,000 in 2010. Growth in 401(k) expenses after 2010 is projected to increase approximately at the same rate of increase as salaries.

The Bank expects personnel costs, consisting primarily of salary and benefits, to continue to be its largest other expense. As such, the most important factor with regard to potential changes in other expenses is the expansion of staff. The cost of any additional staff expansion, however, would be expected to be offset by the increased revenue generated by the additional services that the new staff would enable the Bank to perform. For the remainder of 2010, the Company plans to add no new full-time positions and will fill two currently vacant positions.

Net occupancy expense increased $125,000 or 39.3%, and furniture and equipment expense increased $22,000 or 8.3%, from the second quarter of 2009 to the second quarter to 2010. The increase in occupancy expense and furniture and equipment expense primarily reflects the increases in rent, building depreciation, and furniture and equipment depreciation associated with the opening of the Bristow and Haymarket branch offices, and the new location of the Warrenton-View Tree office, none of which were in operation during the second quarter of 2009.

Marketing expense decreased $23,000 or 12.2% from $187,000 for the second quarter of 2009 to $164,000 for the second quarter of 2010. Marketing expenses for all of 2010 are projected to be approximately the same as 2009.

Legal, accounting and consulting expense decreased $182,000 or 38.2% in the second quarter of 2010 compared with the second quarter of 2009. The decrease of legal fees was associated with the 2009 annual meeting and contested election of directors, which was atypical, and did not reoccur in 2010.

FDIC deposit insurance expense decreased 55.7% from $385,000 for the second quarter of 2009 to $170,000 for the second of 2010. During the June 2009 quarter, the Bank paid a $240,000 special assessment required by the FDIC. Projections of future FDIC expense are difficult when taking into consideration the possibility of additional special assessments required by the FDIC.

Data processing expense increased $45,000 or 13.5% for the second quarter of 2010 compared with the same time period in 2009. The Bank outsources much of its data processing to a third-party vendor. The growth in expense reflects the growth in the Bank s deposit transactions.

Other operating expenses increased $13,000 or 1.8% in the second quarter of 2010 compared with the second quarter of 2009.

INCOME TAXES

Income tax expense was $356,000 for the quarter ended June 30, 2010 compared with $272,000 for the quarter ended June 30, 2009. The effective tax rates were 26.0% and 27.3% for the second quarter of 2010 and 2009, respectively. The effective tax rate differs from the statutory federal income tax rate of 34% due to the Bank s investment in tax-exempt loans and securities, and income from the BOLI purchases.

COMPARISON OF OPERATING RESULTS FOR THE SIX MONTHS ENDED JUNE 30, 2010 AND JUNE 30, 2009

NET INCOME

Net income of $1.81 million for the first six months of 2010 was a 10.2% increase from the net income for the first six months of 2009 of $1.65 million. Earnings per share on a fully diluted basis were $0.50 for the first six months of 2010 compared to $0.46 for the first six months of 2009. Profitability as measured by return on average assets remained at 0.64% in the first six months of 2009 and 2010. Profitability as measured by return on average equity increased from 7.94% to 8.22% over the same respective quarters in 2009 and 2010. The increase in net income and the corresponding profitability measures was primarily due to the $974,000 increase in net interest income in the first six months of 2010 compared with the first six months of 2009.

NET INTEREST INCOME AND EXPENSE

Net interest income increased $974,000 or 9.7% to $11.06 million for the six months ended June 30, 2010 from $10.08 million for the six months ended June 30, 2009. The increase in net interest income was due to the impact of total average earning assets increasing 9.9% from $488.0 million during the first six months of 2009 to $536.3 million during the first six months of 2010. Additionally, the Company s net interest margin increased from 4.17% in the first six months of 2009 to 4.18% in the first six months of 2010.

Total interest income increased $508,000 or 3.7% to $14.17 million for the first six months of 2010 from $13.67 million for the first six months of 2009. This increase was primarily due to the increase in total average earning assets of $48.2 million from the first six months of 2009 to the first six months of 2010. This was partially offset by the 29 basis point decrease in the yield on average assets from 5.64% to 5.35% over the same time period.

Table of Contents

The average yield on loans was 5.78% for the first six months of 2010 as well as the first six months of 2009. Average loan balances increased $21.8 million or 4.9% from $446.3 million during the first six months of 2009 to $468.1 million during the first six months of 2010. The increase in loans outstanding and constant yield resulted in a $568,000 or 4.4% increase in interest and fee income from loans for the first six months of 2010 compared with the same period in 2009.

Average investment security balances increased $5.7 million from $36.1 million in the first six months of 2009 to $41.8 million in the first six months of 2010. The tax-equivalent average yield on investments decreased from 4.83% for the first six months of 2009 to 3.80% for the first six months of 2010. Together, there was a decrease in interest and dividend income on security investments of $77,000 or 9.5%, from $812,000 for the first six months of 2009 to $735,000 for the first six months of 2010. This decrease was partially due to the suspension of interest payments on the Bank s investment in pooled trust-preferred corporate bonds during the first six months of 2010. Interest income on deposits in other banks increased $17,000 from the first six months of 2009 to the first six months of 2010.

Total interest expense decreased $467,000 or 12.8% from $3.58 million for the first six months of 2009 to $3.12 million for the first six months of 2010 primarily due to the overall decline in shorter-term market interest rates. Interest paid on deposits decreased $388,000 or 12.9% from $3.00 million for the first six months of 2009 to $2.61 million for the first six months of 2010. Average NOW deposit balances increased $22.0 million from the first six months of 2009 to the first six months of 2010, and the average rate on NOW accounts increased from 0.42% to 0.65%, resulting in an increase of $159,000 in NOW interest expense for the first six months of 2010. Average money market account balances decreased $9.1 million from first six months 2009 to first six months 2010, while their average rate decreased from 0.88% to 0.75% over the same period, resulting in a decrease of $81,000 of interest expense for the first six months of 2010. Average savings account balances increased $16.4 million from the first six months of 2009 to the first six months of 2010 while the average rate on time deposits increased from 0.30% to 0.48%, resulting in a increase of $70,000 in interest expense for the first six months of 2010. Average time deposit balances increased $34.1 million from the first six months of 2009 to the first six months of 2010 while the average rate on time deposits decreased from 3.04% to 1.98%, resulting in a decrease of $536,000 in interest expense for the first six months of 2010. The average rate paid on all interest-bearing deposits for the first six months of 2010 was 1.29%, as compared with 1.75% one year earlier.

Interest expense on FHLB of Atlanta advances decreased $30,000 from the first six months of 2009 to the first six months of 2010 due to the one-time gain of $85,000 generated from the early repayment of one $10.0 million FHLB advance, partially offset by an increase in the average rate paid. The average rate paid on FHLB advances increased from 1.72% for the first six months of 2009 to 1.93% for the first six months of 2010 due to the strategic lengthening of advance maturities in order to better offset the potential negative impact of future increases in short-term interest rates. The average rate on total interest-bearing liabilities decreased from 1.76% for the first six months of 2009 to 1.36% for the first six months of 2010.

The following table sets forth information relating to the Company s average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated and the average yields and rates paid for the periods indicated. These yields and costs are derived by dividing income or expense by the average daily balances of assets and liabilities, respectively, for the periods presented.

AVERAGE BALANCES, INCOME AND EXPENSES, AND AVERAGE YIELDS AND RATES
(Dollars in Thousands)

	Six Months Ended June 30, 2010			Six Months Ended June 30, 2009		
	Average Balances	Income/ Expense	Average Rate	Average Balances	Income/ Expense	Average Rate
ASSETS:						
Loans						
Taxable	$ 450,630	$ 13,090	5.79%	$ 436,220	$ 12,654	5.78%
Tax-exempt (1)	14,079	491	6.96%	8,492	291	6.82%
Nonaccrual (2)	3,413			1,552		
Total Loans	468,122	13,581	5.78%	446,264	12,945	5.78%
Securities						
Taxable	36,124	619	3.43%	30,606	692	4.52%
Tax-exempt (1)	5,698	176	6.17%	5,518	181	6.56%
Total securities	41,822	795	3.80%	36,124	873	4.83%
Deposits in banks	26,335	24	0.18%	5,533	7	0.25%
Federal funds sold	9		0.26%	122		0.26%
Total earning assets	536,288	14,400	5.35%	488,043	13,825	5.64%
Less: Reserve for loan losses	(5,509)			(4,948)		
Cash and due from banks	6,025			9,148		
Bank premises and equipment, net	14,509			9,218		
Other real estate owned	2,409			2,523		
Other assets	22,361			17,810		
Total Assets	$ 576,083			$ 521,794		
LIABILITIES & SHAREHOLDERS EQUITY:						
Deposits						
Demand deposits	$ 66,077			$ 63,869		
Interest-bearing deposits						
NOW accounts	98,932	318	0.65%	76,982	159	0.42%
Money market accounts	61,719	230	0.75%	70,813	311	0.88%

Savings accounts	49,410	118	0.48%	33,001	48	0.30%
Time deposits	198,652	1,946	1.98%	164,586	2,482	3.04%
Total interest-bearing deposits	408,713	2,612	1.29%	345,382	3,000	1.75%
Federal funds purchased	28		0.26%	3,488	23	1.32%
Federal Home Loan Bank advances	48,011	466	1.93%	57,480	496	1.72%
Capital securities of subsidiary trust	4,124	40	1.92%	4,124	65	3.15%
Total interest-bearing liabilities	460,876	3,118	1.36%	410,474	3,584	1.76%
Other liabilities	4,605			5,631		
Shareholders equity	44,525			41,820		
Total Liabilities & Shareholders Equity	$ 576,083			$ 521,794		
Net interest spread		$ 11,282	3.99%		$ 10,241	3.88%
Interest expense as a percent of average earning assets			1.17%			1.47%
Net interest margin			4.18%			4.17%

(1) Income and rates on non-taxable assets are computed on a tax equivalent basis using a federal tax rate of 34%.

(2) Nonaccrual loans are included in the average balance of total loans and total earning assets.

RATE/VOLUME ANALYSIS

The following table sets forth certain information regarding changes in interest income and interest expense of the Company for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to changes in volume (change in volume multiplied by old rate); and changes in rates (change in rate multiplied by old volume). Changes in rate-volume, which cannot be separately identified, are allocated proportionately between changes in rate and changes in volume.

RATE / VOLUME VARIANCE
(In Thousands)
Six Months Ended June 30, 2010 Compared to
Six Months Ended June 30, 2009

	Change	Due to Volume	Due to Rate
INTEREST INCOME			
Loans; taxable	$ 436	$ 418	18
Loans; tax-exempt (1)	200	191	9
Securities; taxable	(73)	125	(198)
Securities; tax-exempt (1)	(5)	6	(11)
Deposits in banks	17	26	(9)
Federal funds sold			
Total Interest Income	575	766	(191)
INTEREST EXPENSE			
NOW accounts	159	45	114
Money market accounts	(81)	(40)	(41)
Savings accounts	70	24	46
Time deposits	(536)	514	(1,050)
Federal funds purchased and securities sold under agreements to repurchase	(23)	(23)	
Federal Home Loan Bank advances	(30)	(82)	52
Capital securities of subsidiary trust	(25)		(25)
Total Interest Expense	(466)	438	(904)
Net Interest Income	$ 1,041	$ 328	$ 713

(1) Income and rates on non-taxable assets are computed on a tax equivalent basis using a federal tax rate of 34%.

PROVISION FOR LOAN LOSSES, ALLOWANCE FOR LOAN LOSSES, AND ASSET QUALITY

The provision for loan losses was $750,000 for the first six months of 2010, compared with $560,000 for the first six months of 2009. The $190,000 increase in the provision for loan losses during the first six months of 2010, compared to the same quarter one year earlier, was largely in response to the increase in total loans and non-accrual loans at June 30, 2010 compared with one year earlier.

OTHER INCOME

Total other income increased by $65,000 from $2.36 million for the first six months of 2009 to $2.42 million in the first six months of 2010. The increase in other income was primarily due to the $87,000 gain on the sale of investments, a $165,000 increase in Wealth Management income, and a $75,000 decrease on the loss realized on the sale of other real estate owned properties, partially offset by a $309,000 increase in the impairment losses on pooled trust preferred securities.

Wealth Management income increased $165,000 or 33.3% from the first six months of 2009 to the first six months of 2010, as assets under management increased from year to year, primarily due to the increase in overall stock market valuations as well as the growth in new customer relationships and increased brokerage fee income.

Service charges on deposit accounts decreased $59,000 or 4.5% to $1.27 million for the first six months of 2010 compared to one year earlier. Due to changes in regulations regarding customer usage of overdraft protection services, service charges on deposit accounts are projected to decline during the second half of 2010. Whether this is a temporary change to customer preferences for overdraft protection, or a more permanent structural change, is difficult to determine at this point in time.

Other service charges, commissions and fees increased $106,000 or 12.7% from $836,000 during the first six months of 2009 to $942,000 during the first six months of 2010. Also included in other service charges, commissions, and income is BOLI income, which was $204,000 during the first six months of 2010 compared with $202,000 one year earlier.

OTHER EXPENSE

Total other expense increased $695,000 or 7.2% during the first six months of 2010 compared with the first six months of 2009. Salaries and employees   benefits increased $565,000 or 12.1%, largely due to the same factors causing the growth in salary and benefits for the three months ended June 30, 2010 compared with one year earlier.

Net occupancy expense increased $318,000 or 50.9%, and furniture and equipment expense increased $60,000 or 10.8%, from the first six months of 2009 to the first six months of 2010. The increase in occupancy expense and furniture and equipment expense primarily reflects the increases in rent, building depreciation, and furniture and equipment depreciation associated with the opening of the Bristow and Haymarket branch offices, and the new location of the Warrenton-View Tree office, none of which were in operation during the first six months of 2009. Marketing expense increased $13,000 or 4.1% from $308,000 for the first six months of 2009 to $321,000 for the first six months of 2010. This increase primarily reflects the marketing expense of the grand openings of the Haymarket office and relocation of the Warrenton-View Tree office in early 2010. Legal, accounting and consulting expense decreased $251,000 or 30.9% in the first six months of 2010 compared with the first six months of 2009. The decrease of legal fees was associated with the 2009 annual meeting and contested election of directors, which was atypical, and did not reoccur in 2010. FDIC deposit insurance expense decreased 33.4% from $530,000 for the first six months of 2009 to $353,000 for the first six months of 2010. During the second quarter of 2009, the Bank paid a $240,000 special assessment required by the FDIC. Data processing expense increased $46,000 or 6.6% for the first six months of 2010 compared with the same time period in 2009.

Other operating expenses increased $123,000 or 8.7% in the first six months of 2010 compared with the first six months of 2009. The increase was primarily due to the acceleration in the vesting of directors restricted stock. For additional information regarding the acceleration in the vesting of directors restricted stock, see Stock-Based Compensation in Note 7 of the Notes to Consolidated Financial Statements contained herein.

INCOME TAXES

Income tax expense was $600,000 for the quarter ended June 30, 2010 compared with $614,000 for the quarter ended June 30, 2009. The effective tax rates were 24.8% and 27.1% for the first six months of 2010 and 2009, respectively. The effective tax rate differs from the statutory federal income tax rate of 34% due to the Bank s investment in tax-exempt loans and securities, and income from the BOLI purchases.

COMPARISON OF FINANCIAL CONDITION AT JUNE 30, 2010 AND DECEMBER 31, 2009

Total assets were $586.4 million at June 30, 2010 compared with $568.5 million at December 31, 2009, an increase of 3.1% or $17.9 million. Balance sheet categories reflecting significant changes included interest-bearing deposits in other banks, and deposits. Each of these categories is discussed below.

INTEREST-BEARING DEPOSITS IN OTHER BANKS. Interest-bearing deposits in other banks were $33.3 million at June 30, 2010, reflecting an increase of $12.8 million from December 31, 2009. The increase in interest-bearing deposits in other banks was primarily due the deployment of funds from the growth in deposits.

DEPOSITS. For the six months ended June 30, 2010, total deposits increased by $26.8 million or 5.8% when compared with total deposits at December 31, 2009. Included in time certificates of deposit at June 30, 2010 and December 31, 2009 were $46.2 million and $46.6 million, respectively, of brokered deposits as defined by the Federal Reserve. Of the $46.2 million in brokered deposits at June 30, 2010, $25.3 million represent deposits of Bank customers, exchanged through the CDARS network. With the CDARS program, funds are placed into certificate of deposits issued by other banks in the network, in increments of less than $250,000, to ensure both principal and interest are eligible for complete FDIC coverage. These deposits are exchanged with other member banks on a dollar-for-dollar basis, bringing the full amount of our customers deposits back to the bank and making these funds fully available for lending in our community. The decline in the Bank s non-interest-bearing deposits and the increase in interest-bearing deposits during the first six months of 2010 were the result of many factors difficult to segregate and quantify, and equally difficult to use as factors for future projections. The economy, local competition, retail customer preferences, changes in seasonal cash flows by both commercial and retail customers, changes in business cash management practices by Bank customers, the relative pricing from wholesale funding sources, and the Bank s funding needs all contributed to the change in deposit balances. The Bank projects to increase its transaction accounts and other deposits in 2010 and beyond through the expansion of its branch network, as well as by offering value-added NOW and demand deposit products, and selective rate premiums on its interest-bearing deposits.

Table of Contents

FEDERAL HOME LOAN BANK ADVANCES. Total FHLB of Atlanta advances decreased $10.0 million from December 31, 2009 to June 30, 2010 due to the early repayment of one $10.0 million advance.

ASSET QUALITY

Non-performing assets, in most cases, consist of loans that are 90 days or more past due and for which the accrual of interest has been discontinued. Management evaluates all loans that are 90 days or more past due, as well as borrowers that have suffered financial distress, to determine if they should be placed on non-accrual status. Factors considered by management include the net realizable value of collateral, if any, and other resources of the borrower that may be available to satisfy the delinquency.

Loans are placed on non-accrual status when they have been specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loans are well secured and in the process of collection. Any unpaid interest previously accrued on such loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other non-accrual loans is recognized only to the extent of interest payments received.

Non-performing assets totaled $6.5 million or 1.12% of total assets at June 30, 2010, compared with $7.1 million or 1.24% of total assets at December 31, 2009, and $3.2 million, or 0.61% of total assets at June 30, 2009. Included in non-performing assets at June 30, 2010 were $1.6 million of non-performing pooled trust preferred bonds at market value, $2.4 million of other real estate owned and $2.5 million of non-accrual loans. Non-accrual loans as a percentage of total loans were 0.53% at June 30, 2010, as compared with 0.73% and 0.25% at December 31, 2009 and June 30, 2009, respectfully.

There were no loans past due 90 days or more and still accruing interest at June 30, 2010 compared with $354,000 and $780,000 on December 31, 2009 and June 30, 2009, respectively. There are no loans or securities, other than those disclosed above as either non-performing or impaired, where information known about the borrower has caused management to have serious doubts about the borrower s ability to repay.

The following table sets forth certain information with respect to the Bank s past due loans:

Age Analysis of Past Due Financing Receivables
(In thousands)
At June 30, 2010

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Total Loans	Past due as Percentage of Loans
Secured by real estate:						
Construction	$	$	$	$	$ 35,834	0.00%
Farmland					1,090	0.00%
1-4 Family Residential	2,581	992	279	3,852	191,258	2.01%
Commercial Real Estate	423		1,538	1,961	189,249	1.04%
Commercial and Industrial	1,044		194	1,238	28,253	4.38%
Consumer	253	12	5	270	8,350	3.23%
Other					14,331	0.00%
Total	$ 4,301	$ 1,004	$ 2,016	$ 7,321	$ 468,365	1.56%

At December 31, 2009

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Total Loans	Past due as Percentage of Loans
Secured by real estate:						
Construction	$	$	$	$	$ 33,003	0.00%
Farmland					948	0.00%
1-4 Family Residential	1,978	469	432	2,879	193,709	1.49%
Commercial Real Estate	354	123	1,720	2,197	186,463	1.18%
Commercial and Industrial	781	168	764	1,713	29,286	5.85%
Consumer	137	30	41	208	10,390	2.00%
Other					14,559	0.00%
Total	$ 3,250	$ 790	$ 2,957	$ 6,997	$ 468,358	1.49%

At June 30, 2009

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Total Loans	Past due as Percentage of Loans
Secured by real estate:						
Construction	$	$	$	$	$ 41,899	0.00%
Farmland					1,268	0.00%
1-4 Family Residential	4,069	448	481	4,998	182,800	2.73%
Commercial Real Estate		1,601	466	2,067	172,559	1.20%
Commercial and Industrial	1,503	419	632	2,554	39,406	6.48%
Consumer	202		96	298	13,151	2.27%
Other					6,979	0.00%
Total	$ 5,774	$ 2,468	$ 1,675	$ 9,917	$ 458,062	2.16%

Table of Contents

At June 30, 2010, no concentration of loans to commercial borrowers engaged in similar activities exceeded 10% of total loans. The largest industry concentration at June 30, 2010 was approximately 5.1% of loans to the hospitality industry (hotels, motels, inns, etc.). For more information regarding the Bank s concentration of loans collateralized by real estate, please refer to the discussion under Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2009 entitled The Company has a high concentration of loans secured by both residential and commercial real estate and a downturn in either or both markets, for any reason, may continue to increase the Company s credit losses, which would negatively affect our financial results.

Based on regulatory guidelines, the Bank is required to monitor the commercial investment real estate loan portfolio for: (a) concentrations above 100% of Tier 1 capital and loan loss reserve for construction and land loans and (b) 300% for permanent investor real estate loans. As of June 30, 2010, construction and land loans were $36.6 million or 61.9% of the concentration limit. Commercial real estate loans, including construction and land loans, were $131.8 million or 223.7% of the concentration level.

Potential Problem Loans: For additional information regarding non-performing assets and potential loan problems, see Allowance for Loan Losses in Note 4 of the Notes to Consolidated Financial Statements contained herein.

CONTRACTUAL OBLIGATIONS

As of June 30, 2010, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operations in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

OFF-BALANCE SHEET ARRANGEMENTS

As of June 30, 2010, there have been no material changes to the off-balance sheet arrangements disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operations in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. Subsequent to June 30, 2010, the Company entered into an off-balance sheet cash flow swap for the purpose of offsetting the interest rate volatility of the Company s $4 million Floating Rate Capital Security issued by its subsidiary trust. See Company-obligated Mandatorily Redeemable Capital Securities of Subsidiary Trust in Note 5 of the Notes to Consolidated Financial Statements for more information on this off-balance sheet cash flow swap.

CAPITAL

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier 1 Capital to average assets (as defined in the regulations). Management believes, as of June 30, 2010, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

At June 30, 2010 and December 31, 2009, the Company exceeded its regulatory capital ratios, as set forth in the following table:

Table of Contents

RISK BASED CAPITAL RATIOS
(Dollars in Thousands)

	June 30, 2010	December 31, 2009
Tier 1 Capital:		
Shareholders Equity	$ 43,874	$ 42,639
Plus: Unrealized loss on securities available for sale/FAS 158, net	1,536	1,919
Less: Unrealized loss on equity securities, net	(5)	(4)
Plus: Company-obligated madatorily redeemable capital securities	4,000	4,000
Total Tier 1 Capital	49,405	48,554
Tier 2 Capital:		
Allowable Allowance for Loan Losses	5,397	5,485
Total Capital:	54,802	54,039
Risk Weighted Assets:	$ 438,674	$ 442,658
Regulatory Capital Ratios:		
Leverage Ratio	8.42%	8.68%
Tier 1 to Risk Weighted Assets	11.26%	10.97%
Total Capital to Risk Weighted Assets	12.49%	12.21%

CAPITAL RESOURCES AND LIQUIDITY

Shareholders equity totaled $43.9 million at June 30, 2010 compared with $42.6 million at December 31, 2009 and $41.3 million at June 30, 2009. The amount of equity reflects management s desire to increase shareholders return on equity while maintaining a strong capital base. The Company initiated an open market stock buyback program in 1998, but did not repurchase any shares during the first six months of 2010 and 2009, respectively.

Accumulated other comprehensive income/loss decreased to an unrealized loss net of tax benefit of $1.5 million at June 30, 2010 compared with $1.9 million at December 31, 2009. The decline in the magnitude of the accumulated other comprehensive loss was primarily attributable to the realization of an other-than temporary impairment loss of $476,000 on pooled trust preferred investment securities held available for sale.

As discussed in Company-obligated Mandatorily Redeemable Capital Securities of Subsidiary Trust in Note 5 of the Notes to Consolidated Financial Statements contained herein, during 2006, the Company established a subsidiary trust that issued $4.0 million of capital securities as part of a separate pooled trust preferred security offering with other financial institutions. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve s capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital. As discussed above under Capital, banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios. As of June 30, 2010, the appropriate regulatory authorities have categorized the Company and the Bank as well capitalized.

The primary sources of funds are deposits, repayment of loans, maturities of investments, funds provided from operations, federal funds lines of credit with the Federal Reserve and other banks, and advances from the FHLB of Atlanta. While scheduled repayments of loans and maturities of investment securities are predictable sources of funds,

deposit flows and loan repayments are greatly influenced by the general level of interest rates, economic conditions and competition. The Bank uses its sources of funds to fund existing and future loan commitments, to fund maturing certificates of deposit and demand deposit withdrawals, to invest in other interest-earning assets, to maintain liquidity, and to meet operating expenses. Management monitors projected liquidity needs and determines the desirable funding level based in part on the Bank s commitments to make loans and management s assessment of the Bank s ability to generate funds. Management is not aware of any market or institutional trends, events or uncertainties that are expected to have a material effect on the liquidity, capital resources or operations of the Company or the Bank. Nor is management aware of any current recommendations by regulatory authorities that would have a material effect on liquidity, capital resources or operations. The Bank s internal sources of such liquidity are deposits, loan and investment repayments, and securities available for sale. The Bank s primary

external sources of liquidity are federal funds lines of credit with the Federal Reserve Bank and other banks and advances from the FHLB of Atlanta.

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled $38.7 million at June 30, 2010 compared with $26.2 million at December 31, 2009. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available of sale, of which approximately $10.7 million was unpledged and readily salable at June 30, 2010. Furthermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately $121.7 million at June 30, 2010 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with the Federal Reserve Bank and various other commercial banks totaling approximately $68.3 million. At June 30, 2010, $40.0 million of the FHLB of Atlanta line of credit and none of federal funds purchased lines of credit were in use.

The following table sets forth information relating to the Company s sources of liquidity and the outstanding commitments for use of liquidity at June 30, 2010 and December 31, 2009. The liquidity coverage ratio is derived by dividing the total sources of liquidity by the outstanding commitments for use of liquidity.

LIQUIDITY SOURCES AND USES
(Dollars in Thousands)

	June 30, 2010			**December 31, 2009**		
	Total	**In Use**	**Available**	**Total**	**In Use**	**Available**
Sources:						
Federal funds borrowing lines of credit	$ 68,288	$	$ 68,288	$ 72,563	$	$ 72,563
Federal Home Loan Bank advances	121,695	40,000	81,695	108,310	50,000	58,310
Federal funds sold and interest-bearing deposits in other banks, excluding requirements			24,052			13,617
Securities, available for sale and unpledged at fair value			10,743			10,730
Total short-term funding sources			$ 184,778			$ 155,220
Uses:						
Unfunded loan commitments and lending lines of credit			$ 66,985			$ 71,523
Letters of credit			5,766			8,585
Total potential short-term funding uses			$ 72,751			$ 80,108
Ratio of short-term funding sources to			254.0%			193.8%

potential short-term
funding uses

IMPACT OF INFLATION AND CHANGING PRICES

The consolidated financial statements and the accompanying notes presented elsewhere in this document have been prepared in accordance with accounting principles generally accepted in the United States of America, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of the Company and the Bank are monetary in nature. The impact of inflation is reflected in the increased cost of operations. As a result, interest rates have a greater impact on our performance than inflation does. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

An important component of both earnings performance and liquidity is management of interest rate sensitivity. Interest rate sensitivity reflects the potential effect on net interest income and economic value of equity from a change in market interest rates. The Bank is subject to interest rate sensitivity to the degree that its interest-earning assets mature or reprice at different time intervals than its interest-bearing liabilities. However, the Bank is not subject to the other major categories of market risk such as foreign currency exchange rate risk or commodity price risk. The Bank uses a number of tools to manage its interest rate risk, including simulating net interest income under various scenarios, monitoring the present value change in equity under the same scenarios, and monitoring the difference or gap between rate sensitive assets and rate sensitive liabilities over various time periods. Management believes that rate risk is best measured by simulation modeling.

There have been no material changes to the quantitative and qualitative disclosures made in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to provide assurance that the information required to be disclosed in the reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods required by the Securities and Exchange Commission. An evaluation of the effectiveness of the design and operations of the Company s disclosure controls and procedures at the end of the period covered by this report was carried out under the supervision and with the participation of the management of Fauquier Bankshares, Inc., including the Chief Executive Officer and the Chief Financial Officer. Based on such an evaluation, the Chief Executive Officer and the Chief Financial Officer concluded the Company s disclosure controls and procedures were effective as of the end of such period.

As of June 30, 2010, management has assessed the effectiveness of the internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the assessment, management determined that it maintained effective internal control over the financial reporting as of June 30, 2010, based on those criteria, and the Company s Chief Executive Officer and Chief Financial Officer can provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America.

Smith Elliott Kearns & Company, LLC, the independent registered public accounting firm that audited the Company s consolidated financial statements included in the Company s Annual Report on 10-K for the year ended December 31, 2009, has issued an audit report on the Company s effectiveness of internal control over financial reporting as of December 31, 2009. The auditor s report is incorporated by reference in the Company s Annual Report on 10-K for the year ended December 31, 2009 in Item 8 under the heading Report of Independent Public Accounting Firm.

No changes were made in management s internal control over financial reporting during the quarter ended June 30, 2010 that have materially affected, or that are reasonably likely to materially affect, Management s internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

There are no pending or threatened legal proceedings to which the Company or the Bank is a party or to which the property of either the Company or the Bank is subject to that, in the opinion of management, may materially impact the financial condition of either the Company or the Bank.

Table of Contents

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors faced by the Company from those disclosed in Company s Annual Report on Form 10-K for the year ended December 31, 2009.

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

None. On January 21, 2010, the Board authorized the Company to repurchase up to 107,840 shares (3% of common stock outstanding on January 1, 2010) beginning January 1, 2010. No shares were repurchased during the six months ended June 30, 2010.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

On August 5, 2010, the Board of Directors of Fauquier Bankshares, Inc. (the Company) adopted amendments to the Company s By-laws. The amendments include, among other items:

- Eliminating the ability of three or more stockholders with a collective ownership of 25% or more of the Company s common stock from calling a special meeting of stockholders. (Section 1.3)
- Permitting a notice of meeting of stockholders to be given in any manner permitted by the Virginia Stock Corporation Act (the VSCA), including by electronic transmission. (Section 1.4)
- Changing the timing of the notice requirement for a stockholder requesting that certain business be conducted at a stockholders meeting from not less than 60 days to not less than 120 days prior to the anniversary date of the previous year s proxy statement; clarifying certain notice requirements for such a stockholder s request so that the notice must (i) state the reasons for conducting such business at the meeting, (ii) disclose any material interest of the stockholder in such business, and (iii) contain a representation that the stockholder will notify the Company of any changes to the information provided in the notice. (Section 1.5)
- Removing language permitting the exact number of directors to be established within a range by resolution of the stockholders at any meeting of the stockholders and retaining the right of the number of directors to be set by the full Board of Directors by resolution. (Section 2.2)
- Clarifying the timing on when a stockholder is required to give notice for a director nomination so that notice must be received by the Company not less than 120 days prior to the anniversary date of the previous year s proxy statement (the provision on timing of the notice had previously called for notice not less than 30 days prior to the first anniversary date of the initial notice given to stockholders of record for the previous annual meeting by or at the direction of the Board of Directors, provided, however, that the notice was not required to be given more than 90 days prior to the annual meeting of stockholders); adding a provision that a stockholder is to provide a description of any agreement, arrangement or understanding with respect to any nomination between or among the stockholder or any other person on whose behalf the nomination is made and any of its affiliates or associates; and adding a provision that a stockholder provide a representation that the stockholder will notify the Company of any changes to the information provided in the notice. (Section 2.4)
- Eliminating a provision permitting a former director to become a director-emeritus for a three-year term, and allowing such director-emeritus to attend meetings of the Board of Directors of the Company and be paid a fee equal to the regular fee paid to a director. (Section 2.7)
- Eliminating the provision requiring that the Chairman and President are ex officio members of all committees. (Sections 4.4 and 4.5)

The above description of the amendments is not complete and is qualified in its entirety by reference to the Company s Amended and Restated By-laws, as amended, a copy of which is filed as Exhibit 3.2 to this report and is incorporated herein by reference.

ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description
3.1	Articles of Incorporation of Fauquier Bankshares, Inc., as amended, incorporated by reference to Exhibit 3.1 to Form 10-K filed March 15, 2010.

3.2	Bylaws of Fauquier Bankshares, Inc., as amended and restated.
31.1	Certification of CEO pursuant to Rule 13a-14(a).
31.2	Certification of CFO pursuant to Rule 13a-14(a).
32.1	Certification of CEO pursuant to 18 U.S.C. Section 1350.
32.2	Certification of CFO pursuant to 18 U.S.C. Section 1350.

Table of Contents

SIGNATURES

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

FAUQUIER BANKSHARES, INC.
(Registrant)

/s/ Randy K. Ferrell
Randy K. Ferrell
President & Chief Executive Officer

Dated: August 9, 2010

/s/ Eric P. Graap
Eric P. Graap
Executive Vice President & Chief Financial Officer

Dated: August 9, 2010