

FAUQUIER BANKSHARES, INC.  
Form 10-Q  
November 14, 2013  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q  
(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2013

or

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  No

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  No

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  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

Yes  No

The registrant had 3,713,342 shares of common stock outstanding as of November 5, 2013.

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FAUQUIER BANKSHARES, INC.  
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## Part I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## Fauquier Bankshares, Inc. and Subsidiaries

## Consolidated Balance Sheets

	September 30, 2013 (Unaudited)	December 31, 2012 (Audited)
(In thousands, except share and per share data)		
Assets		
Cash and due from banks	\$ 5,112	\$4,684
Interest-bearing deposits in other banks	48,539	59,740
Federal funds sold	9	11
Securities available for sale	50,100	48,092
Restricted investments	1,462	2,337
Loans	455,005	451,366
Allowance for loan losses	(6,481 )	(6,258 )
Net loans	448,524	445,108
Bank premises and equipment, net	14,833	14,763
Accrued interest receivable	1,386	1,283
Other real estate owned, net of allowance	1,406	1,406
Bank-owned life insurance	12,335	12,038
Other assets	11,743	11,925
Total assets	\$ 595,449	\$ 601,387
Liabilities		
Deposits:		
Noninterest-bearing	\$ 91,589	\$ 89,264
Interest-bearing:		
Checking	204,108	191,039
Savings and money market accounts	117,065	108,794
Time deposits	110,041	126,037
Total interest-bearing	431,214	425,870
Total deposits	522,803	515,134
Federal Home Loan Bank advances	13,155	28,200
Company-obligated mandatorily redeemable capital securities	4,124	4,124
Other liabilities	6,482	6,181
Commitments and contingencies		
Total liabilities	546,564	553,639
Shareholders' Equity		
Common stock, par value, \$3.13; authorized 8,000,000 shares; issued and outstanding: 2013: 3,713,342 shares including 34,109 non-vested shares: 2012: 3,695,160 shares including 31,423 non-vested shares	11,516	11,467
Retained earnings	39,647	37,993
Accumulated other comprehensive income (loss), net	(2,278 )	(1,712 )

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Total shareholders' equity	48,885	47,748
Total liabilities and shareholders' equity	\$ 595,449	\$ 601,387

See accompanying Notes to Consolidated Financial Statements.

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
(Unaudited)  
For the Three Months Ended September 30, 2013 and 2012

(In thousands, except per share data)

	2013	2012
Interest Income		
Interest and fees on loans	\$5,490	\$5,942
Interest and dividends on securities available for sale:		
Taxable interest income	221	230
Interest income exempt from federal income taxes	62	62
Dividends	30	28
Interest on deposits in other banks	38	26
Total interest income	5,841	6,288
Interest Expense		
Interest on deposits	556	693
Interest on Federal Home Loan Bank advances	83	234
Distribution on capital securities of subsidiary trusts	50	50
Total interest expense	689	977
Net interest income	5,152	5,311
Provision for loan losses	333	550
Net interest income after provision for loan losses	4,819	4,761
Other Income		
Trust and estate income	364	336
Brokerage income	83	75
Service charges on deposit accounts	765	664
Other service charges, commissions and income	477	467
Gain on sale of securities	-	2
Total other income	1,689	1,544
Other Expenses		
Salaries and benefits	2,302	2,360
Occupancy expense of premises	492	484
Furniture and equipment	249	283
Marketing expense	162	202
Legal, audit and consulting expense	314	261
Data processing expense	349	294
Federal Deposit Insurance Corporation expense	120	121
Loss on sale or impairment and expense of other real estate owned, net	-	8
Other operating expenses	938	628
Total other expenses	4,926	4,641
Income before income taxes	1,582	1,664

Income tax expense	418	452
Net Income	\$1,164	\$1,212
Earnings per Share, basic	\$0.31	\$0.33
Earnings per Share, assuming dilution	\$0.31	\$0.33
Dividends per Share	\$0.12	\$0.12

See accompanying Notes to Consolidated Financial Statements.

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
(Unaudited)  
For the Nine Months September 30, 2013 and 2012

(In thousands, except per share data)	2013	2012
Interest Income		
Interest and fees on loans	\$16,300	\$18,047
Interest and dividends on securities available for sale:		
Taxable interest income	637	772
Interest income exempt from federal income taxes	184	185
Dividends	66	68
Interest on deposits in other banks	123	88
Total interest income	17,310	19,160
Interest Expense		
Interest on deposits	1,719	2,260
Interest on Federal Home Loan Bank advances	523	721
Distribution on capital securities of subsidiary trusts	149	150
Total interest expense	2,391	3,131
Net interest income	14,919	16,029
Provision for loan losses	1,300	3,850
Net interest income after provision for loan losses	13,619	12,179
Other Income		
Trust and estate income	1,087	1,079
Brokerage income	326	237
Service charges on deposit accounts	2,092	2,010
Other service charges, commissions and income	1,364	1,301
Gain on sale of securities	-	165
Total other income	4,869	4,792
Other Expenses		
Salaries and benefits	7,114	7,123
Occupancy expense of premises	1,453	1,429
Furniture and equipment	777	869
Marketing expense	452	522
Legal, audit and consulting expense	952	793
Data processing expense	996	912
Federal Deposit Insurance Corporation expense	388	345
Loss on sale or impairment and expense of other real estate owned, net	9	13
Other operating expenses	2,453	2,093
Total other expenses	14,594	14,099
Income before income taxes	3,894	2,872
Income tax expense	964	627

Net Income	\$2,930	\$2,245
Earnings per Share, basic	\$0.79	\$0.61
Earnings per Share, assuming dilution	\$0.79	\$0.61
Dividends per Share	\$0.36	\$0.36

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)  
 For the Three Months Ended September 30, 2013 and 2012

(In thousands)	2013	2012
Net Income	\$1,164	\$1,212
Other comprehensive income, net of tax:		
Interest rate swap, net of tax effect of \$0 in 2013 and \$26 in 2012	-	(51 )
Change in fair value of securities available-for-sale net of tax effect of \$(14) in 2013 and \$(88) in 2012	28	172
Adjustment for gain on sale of securities available-for-sale, net of tax of \$0 in 2013 and \$1 in 2012	-	(1 )
Total other comprehensive income (loss), net of tax of \$(14) in 2013 and \$(61) in 2012	28	120
Comprehensive Income (Loss)	\$1,192	\$1,332

For the Nine Months Ended September 30, 2013 and 2012

(In thousands)	2013	2012
Net Income	\$2,930	\$2,245
Other comprehensive income, net of tax:		
Interest rate swap, net of tax effect of \$(86) in 2013 and \$216 in 2012	166	(419 )
Change in fair value of securities available-for-sale net of tax effect of \$377 in 2013 and \$(126) in 2012	(732 )	244
Adjustment for gain on sale of securities available-for-sale, net of tax of \$0 in 2013 and \$56 in 2012		(109 )
Total other comprehensive income (loss), net of tax of \$292 in 2013 and \$146 in 2012	(566 )	(284 )
Comprehensive Income	\$2,364	\$1,961

See accompanying Notes to Consolidated Financial Statements

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Changes in Shareholders' Equity  
(Unaudited)  
For the Nine Months Ended September 30, 2013 and 2012

(In thousands)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2011	\$ 11,384	\$ 37,504	\$ (1,317 )	\$ 47,571
Net income		2,245		2,245
Other comprehensive income (loss) net of tax effect of \$146			(284 )	(284 )
Cash dividends (\$.36 per share)		(1,330 )		(1,330 )
Amortization of unearned compensation, restricted stock awards		104		104
Issuance of common stock – non-vested shares (13,074 shares)	41	(41 )		-
Issuance of common stock - vested shares (13,477 shares)	42	111		153
Balance, September 30, 2012	\$ 11,467	\$ 38,593	\$ (1,601 )	\$ 48,459
Balance, December 31, 2012	\$ 11,467	\$ 37,993	\$ (1,712 )	\$ 47,748
Net income		2,930		2,930
Other comprehensive income(loss) net of tax effect of \$292			(566 )	(566 )
Cash dividends (\$.36 per share)		(1,337 )		(1,337 )
Amortization of unearned compensation, restricted stock awards		111		111
Issuance of common stock – non-vested shares (9,784 shares)	31	(31 )		-
Issuance of common stock - vested shares (5,712 shares)	18	50		68
Tax effect of restricted stock grant		(69 )		(69 )
Balance, September 30, 2013	\$ 11,516	\$ 39,647	\$ (2,278 )	\$ 48,885

See accompanying Notes to Consolidated Financial Statements

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
(Unaudited)  
For the Nine Months Ended September 30, 2013 and 2012

(In thousands)	2013	2012
Cash Flows from Operating Activities		
Net income	\$2,930	\$2,245
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	832	881
Loss on disposal of obsolete assets	11	-
Provision for loan losses	1,300	3,850
(Gain) on interest rate swaps	(38 )	-
(Gain) on sale and call of securities	-	(165 )
Amortization of security premiums, net	47	26
Amortization of unearned compensation, net of forfeiture	111	104
Tax effect of vested stock grant	(69 )	-
Changes in assets and liabilities:		
(Increase) decrease in other assets	127	(1,321 )
Increase (decrease) in other liabilities	798	(1,401 )
Net cash provided by operating activities	6,049	4,219
Cash Flows from Investing Activities		
Proceeds from sale of securities available for sale	-	3,684
Proceeds from maturities, calls and principal payments of securities available for sale	13,625	15,858
Purchase of securities available for sale	(16,789)	(24,717)
Purchase of premises and equipment	(913 )	(1,150 )
Redemptions restricted securities	875	350
Net (increase) decrease in loans	(4,977 )	2,932
Net cash (used in) investing activities	(8,179 )	(3,043 )
Cash Flows from Financing Activities		
Net increase (decrease) in demand deposits, NOW accounts and savings accounts	23,665	(6,745 )
Net decrease in certificates of deposit	(15,996)	(31,820)
Decrease in FHLB advances	(15,045)	-
Cash dividends paid on common stock	(1,337 )	(1,330 )
Issuance of common stock	68	153
Net cash (used in) financing activities	(8,645 )	(39,742)
(Decrease) in cash and cash equivalents	(10,775)	(38,566)
Cash and Cash Equivalents		
Beginning	64,435	72,160
Ending	\$53,660	\$33,594
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$2,480	\$3,194

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Income taxes	\$11	\$2,038
Supplemental Disclosures of Noncash Investing Activities		
Unrealized gain (loss) on securities available for sale, net of tax effect	\$(732	) \$135
Unrealized gain (loss) on interest rate swap, net of taxes	\$166	\$(419 )

See accompanying Notes to Consolidated Financial Statements.

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Notes to Consolidated Financial Statements

Note 1. General

The consolidated financial 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 September 30, 2013 and December 31, 2012 and the results of operations for the three and nine months ended September 30, 2013 and 2012. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's 2012 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the "SEC").

The results of operations for the nine months ended September 30, 2013 are not necessarily indicative of the results expected for the full year.

Recent Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2011-11, "Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued ASU 2013-01, "Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." The amendments in this ASU clarify the scope for derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements and securities borrowing and securities lending transactions that are either offset or subject to netting arrangements. An entity is required to apply the amendments for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in the consolidated financial statements.

Notes to Consolidated Financial Statements  
 Note 2. Securities

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

(In thousands)	September 30, 2013			
	Gross		Gross	
	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	(Losses)	Value
Obligations of U.S. Government corporations and agencies	\$42,331	\$ 373	\$ (474 )	\$42,230
Obligations of states and political subdivisions	6,782	297	(1 )	7,078
Corporate bonds	3,861	-	(3,421 )	440
Mutual funds	351	1	-	352
	\$53,325	\$ 671	\$ (3,896 )	\$50,100
	December 31, 2012			
	Gross		Gross	
	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	(Losses)	Value
Obligations of U.S. Government corporations and agencies	\$39,240	\$ 794	\$ (20 )	\$40,014
Obligations of states and political subdivisions	6,786	604	-	7,390
Corporate bonds	3,836	-	(3,511 )	325
Mutual funds	346	17	-	363
	\$50,208	\$ 1,415	\$ (3,531 )	\$48,092

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.

(In thousands)	September 30, 2013	
	Amortized	Fair
	Cost	Value
Due in one year or less	\$1,999	\$2,023
Due after one year through five years	10,044	9,961
Due after five years through ten years	13,816	14,111
Due after ten years	27,115	23,653
Equity securities	351	352
	\$53,325	\$50,100

There were no impairment losses on securities during the three and nine months ended September 30, 2013 and 2012.

During the nine months ended September 30, 2013, no securities were sold, and six securities totaling a fair value of \$7.0 million were called or matured. Over the same period, fourteen securities totalling \$16.8 million were purchased.

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



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September 30, 2013 and December 31, 2012, respectively.

(In thousands)	Less than 12		12 Months or		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
September 30, 2013						
Obligations of U.S. Government, corporations and agencies	\$22,412	\$ (474 )	\$-	\$ -	\$22,412	\$ (474 )
Obligations of states and political subdivisions	513	(1 )	-	-	513	(1 )
Corporate bonds	-	-	440	(3,421 )	440	(3,421 )
Total temporary impaired securities	\$22,925	\$ (475 )	\$440	\$ (3,421 )	\$23,365	\$ (3,896 )
December 31, 2012						
Obligations of U.S. Government, corporations and agencies	\$2,165	\$ (20 )	\$-	\$ -	\$2,165	\$ (20 )
Obligations of states and political subdivisions	-	-	-	-	-	-
Corporate bonds	-	-	325	(3,511 )	325	(3,511 )
Total temporary impaired securities	\$2,165	\$ (20 )	\$325	\$ (3,511 )	\$2,490	\$ (3,531 )

The nature of securities which were temporarily impaired for a continuous twelve month period or more at September 30, 2013 consisted of four corporate bonds with a cost basis net of other-than-temporary impairment ("OTTI") totaling \$3.9 million and a temporary loss of approximately \$3.4 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 evaluate the financial condition of the individual creditors in order to estimate 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. The trust preferred securities are collateralized by the interest and principal payments made on trust preferred capital offerings by a geographically diversified pool of approximately 59 different financial institutions per bond. They have an estimated maturity of 20 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 OTTI test under authoritative accounting guidance as of September 30, 2013. Three bonds totaling \$128,000 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 3. One bond, totaling \$312,000 at fair value, has been performing for five consecutive quarters, is projected to repay the full outstanding interest and principal, and is now classified as a performing corporate bond investment.

Notes to Consolidated Financial Statements

Additional information regarding each of the pooled trust preferred securities as of September 30, 2013 follows:

(Dollars in thousands)

Cost, net of OTTI loss	Fair Value	Percent of Underlying Collateral Performing	Percent of Underlying Collateral in Deferral	Percent of Underlying Collateral in Default	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 Comprehensive Loss, net of tax benefit
\$357	\$ 33	65.10	% 5.90	% 29.00	% broken	Caa3	\$ 584	\$ 213	
1,610	312	67.90	% 11.90	% 20.20	% 3.9	% Caa3	348	856	
1,323	60	63.00	% 29.00	% 8.00	% broken	Ca	677	834	
571	35	67.00	% 22.00	% 11.00	% broken	C	429	354	
\$3,861	\$ 440						\$ 2,038	\$ 2,257	

(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. This column represents the percentage of additional defaults among the currently performing and deferred collateral that would result in OTTI loss.

The Company monitors these pooled trust preferred securities in its portfolio as to 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 acknowledges that it may have 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 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):

(In thousands)

Beginning balance as of December 31, 2012	\$2,115
Add: Amount related to the credit loss for which an other-than- temporary impairment was not previously recognized	-
Add: Increases to the amount related to the credit loss for which an other-than temporary impairment was previously recognized	-
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)	(77 )
Ending balance as of September 30, 2013	\$2,038

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$43.3 million and \$41.5 million at September 30, 2013 and December 31, 2012, respectively.

## Notes to Consolidated Financial Statements

## Note 3. Loans and Allowance for Loan Losses

## Allowance for Loan Losses and Recorded Investment in Loans Receivable

As of and for the Nine Months Ended September 30, 2013

(In thousands)	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Unallocated	Total
Allowance for Loan Losses Beginning balance at 12/31/2012	\$932	\$1,685	\$402	\$40	\$-	\$1,691	\$1,336	\$172	\$6,258
Charge-offs	(257 )	(550 )	-	(104 )	-	(82 )	(174 )	-	(1,167 )
Recoveries	59	-	-	23	-	2	6	-	90
Provision	338	1,161	40	64	72	(209 )	(275 )	109	1,300
Ending balance at 9/30/2013	\$1,072	\$2,296	\$442	\$23	\$72	\$1,402	\$893	\$281	\$6,481
Ending balances individually evaluated for impairment	\$219	\$515	\$341	\$-	\$-	\$202	\$-	\$-	\$1,277
Ending balances collectively evaluated for impairment	\$853	\$1,781	\$101	\$23	\$72	\$1,200	\$893	\$281	\$5,204
Loans Receivable Individually evaluated for impairment	\$481	\$6,868	\$4,130	\$-	\$-	\$2,145	\$98		\$13,722
Collectively evaluated for impairment	24,248	176,434	31,702	3,756	24,578	137,411	43,154		441,283
Ending balance at 9/30/2013	\$24,729	\$183,302	\$35,832	\$3,756	\$24,578	\$139,556	\$43,252		\$455,005

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Notes to Consolidated Financial Statements

As of and for the Year Ended December 31, 2012

(In thousands)	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Unallocated	Total
Allowance for Loan Losses Beginning balance at 12/31/2011	\$ 795	\$ 2,899	\$ 195	\$ 31	\$-	\$ 1,584	\$ 698	\$ 526	\$ 6,728
Charge-offs	(526 )	(5,004 )	-	(117 )	-	(126 )	(536 )	-	(6,309 )
Recoveries	7	9	-	14	-	2	-	-	32
Provision	656	3,781	207	112	-	231	1,174	(354 )	5,807
Ending balance at 12/31/2012	\$ 932	\$ 1,685	\$ 402	\$ 40	\$-	\$ 1,691	\$ 1,336	\$ 172	\$ 6,258
Ending balances individually evaluated for impairment	\$ 428	\$-	\$ 293	\$-	\$-	\$ 176	\$ 112	\$-	\$ 1,009
Ending balances collectively evaluated for impairment	\$ 504	\$ 1,685	\$ 109	\$ 40	\$-	\$ 1,515	\$ 1,224	\$ 172	\$ 5,249
Loans Receivable Individually evaluated for impairment	\$ 674	\$ 9,612	\$ 4,175	\$ 4	\$-	\$ 2,372	\$ 228		\$ 17,065
Collectively evaluated for impairment	26,466	183,393	35,870	4,563	4,994	134,218	44,797		434,301
Ending balance at 12/31/2012	\$ 27,140	\$ 193,005	\$ 40,045	\$ 4,567	\$ 4,994	\$ 136,590	\$ 45,025		\$ 451,366

The Company's allowance for loan losses has three basic components: the specific allowance, the general allowance, and the unallocated components. The specific allowance is used to individually allocate an allowance for larger balance, non-homogeneous loans identified as impaired. The general allowance is used for estimating the loss on pools of smaller-balance, homogeneous loans; including 1-4 family mortgage loans, installment loans and other consumer loans. Also, the general allowance is used for the remaining pool of larger balance, non-homogeneous loans which were not identified as impaired. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Credit Quality Indicators

As of September 30, 2013

(In thousands)	Commercial	Commercial	Construction	Consumer	Student	Residential	Total
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	and Industrial	Real Estate	and Land			Real Estate	Home Equity Line of Credit	
Grade:								
Pass	\$ 20,965	\$ 149,331	\$ 31,702	\$ 3,749	\$ 24,578	\$ 125,485	\$ 39,399	\$ 395,209
Special mention	1,332	21,293	-	-	-	6,764	2,751	32,140
Substandard	2,257	12,678	3,994	7	-	6,616	1,102	26,654
Doubtful	175	-	136	-	-	691	-	1,002
Loss	-	-	-	-	-	-	-	-
Total	\$ 24,729	\$ 183,302	\$ 35,832	\$ 3,756	\$ 24,578	\$ 139,556	\$ 43,252	\$ 455,005

As of December 31, 2012

(In thousands)	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Total
Grade:								
Pass	\$ 21,704	\$ 152,483	\$ 35,871	\$ 4,558	\$ 4,994	\$ 120,451	\$ 40,189	\$ 380,250
Special mention	2,635	21,455	-	-	-	9,016	2,878	35,984
Substandard	2,391	19,067	4,038	9	-	6,456	1,958	33,919
Doubtful	410	-	136	-	-	667	-	1,213
Loss	-	-	-	-	-	-	-	-
Total	\$ 27,140	\$ 193,005	\$ 40,045	\$ 4,567	\$ 4,994	\$ 136,590	\$ 45,025	\$ 451,366

Notes to Consolidated Financial Statements  
Age Analysis of Past Due Loans Receivable

	As of September 30, 2013					Total Current	Total Financing Receivables	Carrying Amount > 90 Days and Accruing	Nonaccruals
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Total Past Due				
(In thousands)									
Commercial and industrial	\$-	\$-	\$162	\$162	\$24,567	\$24,729	\$-	\$386	
Commercial real estate	-	-	3,133	3,133	180,169	183,302	-	3,133	
Construction and land	61	-	136	197	35,635	35,832	-	136	
Consumer	37	-	1	38	3,718	3,756	1	-	
Student (U.S. Government guaranteed)	9,399	306	3,629	13,334	11,244	24,578	3,629	-	
Residential real estate	593	486	879	1,958	137,598	139,556	-	1,405	
Home equity line of credit	27	-	-	27	43,225	43,252	-	-	
Total	\$10,117	\$792	\$7,940	\$18,849	\$436,156	\$455,005	\$3,630	\$5,060	

	As of December 31, 2012					Total Current	Total Financing Receivables	Carrying Amount > 90 Days and Accruing	Nonaccruals
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Total Past Due				
(In thousands)									
Commercial and industrial	\$92	\$52	\$41	\$185	\$26,955	\$27,140	\$-	\$643	
Commercial real estate	-	-	7,712	7,712	185,293	193,005	-	7,712	
Construction and land	508	250	136	894	39,151	40,045	-	136	
Consumer	39	10	5	54	4,513	4,567	1	4	
Student (U.S. Government guaranteed)	-	-	-	-	4,994	4,994	-	-	
Residential real estate	2,397	397	1,474	4,268	132,322	136,590	-	1,927	
Home equity line of credit	1,424	-	311	1,735	43,290	45,025	131	228	
Total	\$4,460	\$709	\$9,679	\$14,848	\$436,518	\$451,366	\$132	\$10,650	

The Company began purchasing rehabilitated student loans under the Federal Rehabilitated Student Loan Program during the quarter ended December 31, 2012. The repayment of both principal and accrued interest are 98% guaranteed by the U.S. Department of Education. At September 30, 2013, \$3.6 million of the student loans were 90 days or more past due and still accruing.

Impaired Loans Receivable

(In thousands)	September 30, 2013			
	Recorded Investmen	Unpaid Principal	Related Allowance	Average Recorded Interest Income

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	Balance			Investment	Recognized
With no specific allowance recorded:					
Commercial and industrial	\$151	\$151	\$ -	\$ 177	\$ 5
Commercial real estate	4,292	4,292	-	4,302	72
Construction and land	1,997	1,997	-	2,018	76
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	1,217	1,217	-	1,251	12
Home equity line of credit	98	98	-	249	10
Consumer	-	-	-	-	-
With an allowance recorded:					
Commercial and industrial	\$330	\$330	\$ 219	\$ 344	\$ 2
Commercial real estate	2,576	2,576	515	2,857	68
Construction and land	2,133	2,133	341	2,134	66
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	928	928	202	947	13
Home equity line of credit	-	-	-	-	-
Consumer	-	-	-	-	-
Total:					
Commercial and industrial	\$481	\$481	\$ 219	\$ 521	\$ 7
Commercial real estate	6,868	6,868	515	7,159	140
Construction and land	4,130	4,130	341	4,152	142
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	2,145	2,145	202	2,198	24
Home equity line of credit	98	98	-	249	10
Consumer	-	-	-	-	-
Total	\$13,722	\$13,722	\$ 1,277	\$ 14,279	\$ 323

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## Notes to Consolidated Financial Statements

(In thousands)	December 31, 2012				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance recorded:					
Commercial and industrial	\$ 109	\$ 109	\$ -	\$ 136	\$ 2
Commercial real estate	9,612	12,523	-	11,613	650
Construction and land	3,711	3,711	-	4,134	200
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	1,705	1,705	-	1,734	39
Home equity line of credit	47	47	-	47	1
Consumer	4	4	-	5	-
With an allowance recorded:					
Commercial and industrial	\$ 565	\$ 565	\$ 428	\$ 575	\$ 5
Commercial real estate	-	-	-	-	-
Construction and land	464	464	293	594	21
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	667	667	176	692	-
Home equity line of credit	181	181	112	180	3
Consumer	-	-	-	-	-
Total:					
Commercial and industrial	\$ 674	\$ 674	\$ 428	\$ 711	\$ 7
Commercial real estate	9,612	12,523	-	11,613	650
Construction and land	4,175	4,175	293	4,728	221
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	2,372	2,372	176	2,426	39
Home equity line of credit	228	228	112	227	4
Consumer	4	4	-	5	-
Total	\$ 17,065	\$ 19,976	\$ 1,009	\$ 19,710	\$ 921

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.

At September 30, 2013, there were \$7.8 million of commercial loans classified as substandard which were deemed not to be impaired. Impaired loans totaled \$13.7 million at September 30, 2013, representing a decrease of \$3.3 million from December 31, 2012, due primarily to the payoff of one commercial real estate loan. Approximately \$13.2 million of loans classified as impaired at September 30, 2013 were collateralized by commercial buildings, residential real estate, or land.

No additional funds are committed to be advanced in connection with impaired loans.

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Notes to Consolidated Financial Statements

Troubled Debt Restructurings

	Three Months Ended September 30, 2013			Three Months Ended September 30, 2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
(Dollars in thousands)						
Troubled Debt Restructurings						
Commercial and industrial	2	\$ 292	\$ 94	1	\$ 198	\$ 198
Commercial real estate	-	-	-	1	1,783	1,783
Construction and Land	1	1,673	1,673	1	1,673	1,673
Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-
Home equity line of credit	-	-	-	-	-	-

Troubled Debt Restructurings

That Subsequently Defaulted

Commercial and industrial	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Construction and Land	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-
Home equity line of credit	-	-	-	-	-	-

	Nine Months Ended September 30, 2013			Nine Months Ended September 30, 2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
(Dollars in thousands)						
Troubled Debt Restructurings						
Commercial and industrial	2	\$ 292	\$ 94	2	\$ 435	\$ 435
Commercial real estate	2	2,010	2,010	2	3,683	3,683
Construction and Land	2	2,481	2,481	4	3,473	3,473
Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	1	300	300	-	-	-
Home equity line of credit	-	-	-	-	-	-

Troubled Debt Restructurings

That Subsequently Defaulted

Commercial and industrial	1	237	237	-	-	-
Commercial real estate	-	-	-	-	-	-
Construction and Land	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-

Home equity line of credit       -       -       -       -       -       -

During the quarter ended September 30, 2013, two one commercial and one land loan were modified and deemed Troubled Debt Restructurings ("TDRs") due to extension of maturity dates. At the end of the quarter, thirteen TDRs, totaling \$9.5 million, were in the portfolio. Nine of the loans, totaling \$8.6 million, were on accrual status and performing in accordance with the modified terms. The remaining four loans, totaling \$1.0 million, remained in nonaccrual status due to irregular payments. Appropriate specific reserves have been established. Restructured loans are included in the specific reserve calculation in the allowance for loan losses and are included in impaired loans.

## Notes to Consolidated Financial Statements

## Non-performing Assets, Restructured Loans Still Accruing, and Loans Contractually Past Due

(Dollars in thousands)	September 30, 2013	December 31, 2012	September 30, 2012			
Non-accrual loans	\$ 5,060	\$ 10,650	\$ 12,428			
Other real estate owned	1,406	1,406	1,776			
Non-performing corporate bond investments, at fair value	128	325	303			
Total non-performing assets	6,594	12,381	14,507			
Restructured loans still accruing	8,564	5,556	5,562			
Student loans (U.S. Government guaranteed) past due 90 days or more and still accruing	3,629	-	-			
Loans past due 90 or more days and still accruing	1	132	248			
Total non-performing and other risk assets	\$ 18,788	\$ 18,069	\$ 20,317			
Allowance for loan losses to total loans	1.42	% 1.39	% 1.90	%		
Non-accrual loans to total loans	1.11	% 2.36	% 2.74	%		
Allowance for loan losses to non-accrual loans	128.08	% 58.76	% 69.25	%		
Total non-accrual loans and restructured loans still accruing to total loans	2.99	% 3.59	% 3.96	%		
Allowance for loan losses to non-accrual loans and restructured loans still accruing	47.57	% 38.62	% 47.84	%		
Total non-performing assets to total assets	1.11	% 2.06	% 2.52	%		

Restructured loans on non-accrual status are included with non-accrual loans and not with restructured loans in the above table.

## Note 4. Company-Obligated Mandatorily Redeemable Capital Securities

On September 21, 2006, the Company's wholly-owned Connecticut statutory business trust privately issued \$4.0 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 2.00% above the then current three month LIBOR. Interest is paid quarterly. Total capital securities at September 30, 2013 and December 31, 2012 were \$4,124,000. 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.

## Note 5. Derivative Instruments and Hedging Activities

Accounting principles generally accepted in the United States ("U.S. GAAP") requires that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the date that the derivative contract is entered into, the Company designates the derivative as a hedge of variable cash flows to be paid or received in conjunction with recognized assets or liabilities, as a cash-flow or fair value hedge. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is reported in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income. For a derivative treated as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current earnings in interest income. The Company uses interest rate swaps to reduce interest rate risks and to manage net interest income.

The Company formally assesses, both at the hedges' inception, and on an on-going basis, whether derivatives used in hedging transactions have been highly effective in offsetting changes in cash flows of hedged items and whether those derivatives are expected to remain highly effective in subsequent periods. The Company discontinues hedge accounting when (a) it determines that a derivative is no longer effective in offsetting changes in cash flows of a hedged item; (b) the derivative expires or is sold, terminated or exercised; (c) probability exists that the forecasted transaction will no longer occur; or (d) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all cases in which hedge accounting is discontinued and a derivative remains outstanding, the Company will carry the derivative at fair value in the Consolidated Financial Statements, recognizing changes in fair value in current period income in the consolidated statement of income.

The Company follows U.S. GAAP, FASB ASU 815-10-50 "Disclosures about Derivative Instruments and Hedging Activities", which includes the disclosure requirements for derivative instruments and hedging activities to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows.

Interest differentials paid or received under the swap agreements are reflected as adjustments to interest income.

These interest rate swap agreements include both cash flow and fair value hedge derivative instruments that qualify for hedge accounting. The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counter party, the risk in these transactions is the cost of replacing the agreements at current market rates.

The Company entered into an interest rate swap agreement on July 1, 2010 to manage the interest rate exposure on its Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. By entering into this agreement, the Company converts a floating rate liability into a fixed rate liability through 2020. Under the terms of the agreement, the Company receives interest quarterly at the rate equivalent to three month LIBOR plus 2.00% repricing every three months on the same date as the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036 and pays interest expense monthly at the fixed rate of 4.90%. The interest expense on the interest rate swap was \$30,000 and \$28,000 for the three months ended September 30, 2013 and 2012, respectively. The interest expense was \$89,000 and \$83,000 for the nine months ended September 30, 2013 and 2012, respectively. The swap is designated as a cash flow hedge and changes in the fair value are recorded as an adjustment through other comprehensive income.

The Company entered into three swap agreements to manage the interest rate risk related to three commercial loans.

The agreements allow the Company to convert fixed rate assets to floating rate assets through 2021 and 2022. The Company receives interest monthly at the rate equivalent to one month LIBOR plus a spread repricing on the same date as the loans and pays interest at fixed rates. The interest expense on the interest rate swaps was \$27,000 and \$22,000 for the three months ended September 30, 2013 and 2012, respectively, and is recorded in loan interest income. For the nine months ended September 30, 2013 and 2012, interest expense was \$81,000 and \$68,000, respectively. These swaps are designated as fair value hedges and changes in fair value are recorded in current earnings.

Notes to Consolidated Financial Statements

The effects of derivative instruments on the Consolidated Financial Statements for September 30, 2013 and December 31, 2012 are as follows:

(In thousands)	September 30, 2013			
	Estimated		Fair Value	
Derivatives designated as hedging instruments	Notional/Contract Amount	Net Fair Value	Balance Sheet Location	Expiration Date
Interest rate swap-10 year cash flow	\$4,000	\$ (295)	)Other Liabilities	9/15/2020
Interest rate swap-10 year fair value	2,172	(25)	)Other Liabilities	8/15/2021
Interest rate swap-10 year fair value	2,048	(25)	)Other Liabilities	8/15/2021
Interest rate swap-10 year fair value	1,032	54	Other Assets	9/26/2022

	September 30, 2013		
	Amount of Gain (Loss) Recognized in OCI on Derivatives, net of tax	Location of Gain or (Loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative
Derivatives in cash flow hedging relationships	(Effective Portion)	Income on Derivative	(Ineffective Portion)
Interest rate swap	\$166	Not applicable	\$ -

(In thousands)	September 30, 2013	
Derivatives in fair value hedging relationships	Income Statement Classification	Gain or (Loss) on Swaps
Interest rate swaps	Interest income	\$ 38

(In thousands)	December 31, 2012			
	Estimated		Fair Value	
Derivatives designated as hedging instruments	Notional/Contract Amount	Net Fair Value	Balance Sheet Location	Expiration Date
Interest rate swap-10 year cash flow	\$4,000	\$ (547)	)Other Liabilities	9/15/2020
Interest rate swap-10 year fair value	2,204	(148)	)Other Liabilities	8/15/2021
Interest rate swap-10 year fair value	2,078	(141)	)Other Liabilities	8/15/2021

Interest rate swap-10 year fair value 1,050 (5 )Other Liabilities 9/26/2022

	December 31, 2012	
	Amount	
	of	
	Gain	
	(Loss)	
	Recognized	Amount of
	in	Gain
	OCI	(Loss)
	on	Recognized
	Derivatives,	in Income
	net of	on
Derivatives in cash flow hedging	tax Location of Gain or (Loss) Recognized in Income on	Derivative
relationships	(Effective Derivative	(Ineffective
	Portion)(Ineffective Portion)	Portion)
Interest rate swaps	\$(181)Not applicable	\$ -

(In thousands)	December 31, 2012	
		Gain
		or
		(Loss)
Derivatives in fair value hedging relationships	Income Statement	on
	Classification	Swaps
Interest rate swaps	Interest Income	\$ (51 )

## Notes to Consolidated Financial Statements

## 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.

	Three Months Ended September 30, 2013		Three Months Ended September 30, 2012	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,713,342	\$ 0.31	3,695,160	\$ 0.33
Effect of dilutive securities, stock-based awards	18,546		16,898	
Diluted earnings per share	3,731,888	\$ 0.31	3,712,058	\$ 0.33

	Nine Months Ended September 30, 2013		Nine Months Ended September 30, 2012	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,709,945	\$ 0.79	3,690,294	\$ 0.61
Effect of dilutive securities, stock-based awards	15,572		14,256	
Diluted earnings per share	3,725,517	\$ 0.79	3,704,550	\$ 0.61

## Note 7. Stock Based Compensation

## Stock Incentive Plan

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 certain employees for purchase of the Company's common stock. The effective date of the Plan is March 19, 2009, the date the Company's Board approved the Plan, and it 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 certain employees are generally subject to vesting requirements and are subject to forfeiture if vesting and other contractual provision requirements are not met. Effective January 1, 2000, the Omnibus Stock Ownership and Long-Term Incentive Plan for employees was amended and restated to include non-employee directors. The Company did not grant stock options during the three months or nine months ended September 30, 2013 and there were no options outstanding at September 30, 2013.

## Restricted Shares



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 certain 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 these shares is accrued over the three year period. The restricted share issued to non-employee directors are not subject to a vesting period, and compensation expense is recognized at the date the shares are granted.

The Company has granted awards of non-vested shares to certain officers and vested shares to non-employee directors under the above-described incentive plans: 12,470 shares and 11,925 shares of unvested restricted stock to executive officers, and 5,712 shares and 5,632 shares of vested restricted stock to non-employee directors on February 21, 2013 and February 16, 2012, respectively. Compensation expense for these non-vested shares amounted to \$36,000 and \$35,000, net of forfeiture, for the three months ended September 30, 2013 and 2012, and \$111,000 and \$104,000 for the nine months ended September 30, 2013 and 2012, respectively. Compensation expense for the non-employee director shares is recognized at the date the shares are granted and during the three months ended September 30, 2013 and 2012, none was recognized. For the nine months ended September 30, 2013 and 2012, the compensation expense was \$68,000. As of September 30, 2013, there was \$195,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. This type of deferred compensation cost is recognized over a period of 3 years.

## Notes to Consolidated Financial Statements

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

	Nine Months Ended September 30, 2013	
	Shares	Weighted Average Fair Value
Non-vested at January 1, 2013	31,423	\$ 13.30
Granted	18,182	11.91
Vested	(15,496)	13.09
Forfeited	-	
Non-vested at September 30, 2013	34,109	\$ 12.65

The Company granted performance-based stock rights relating to 12,470 and 11,925 shares to certain officers on February 21, 2013, and February 16, 2012, under the Plan. The performance-based stock rights are accounted for using the fair market value of the Company's common stock on the date awarded, and adjusted as the market value of the stock changes. The performance-based stock rights 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 shares were awarded. Until vesting, the shares are not issued and not included in shares outstanding. The awards are subject to the Company reaching a predetermined three year performance average on the return on average equity ratio, also as compared to a predetermined peer group of banks. The compensation expense for performance-based stock rights totaled \$22,000 and none for the three months ended September 30, 2013 and 2012, respectively. For the nine months ended September 30, 2013 and 2012, compensation expense was \$64,000 and \$(102,000), respectively.

A summary of the status of the Company's non-vested performance-based stock rights is presented below:

	Nine Months Ended September 30, 2013	
	Performance- Based Stock Rights	Weighted Average Fair Value
Non-vested at January 1, 2013	31,423	\$ 13.30
Granted	12,470	11.91
Vested	-	
Forfeited	(9,784 )	13.78
Non-vested at September 30, 2013	34,109	\$ 12.65

## Note 8. Employee Benefit Plans

The Company has a defined contribution retirement plan under Internal Revenue Code ("Code") Section 401(k) covering employees who have completed three months of service and who are at least 18 years of age. Under the plan, a participant may contribute an amount up to 100% of their covered compensation for the year, not to exceed the dollar limit set by law (Code Section 402(g)). The Company will make an annual matching contribution equal to 100% on the first 1% of compensation deferred and 100% on the next 5% of compensation deferred, for a maximum match of 3.5% of compensation. Beginning in 2010, the Company began making an additional safe harbor contribution equal to 6% of compensation to all eligible participants. The Company's 401(k) expenses for the nine months ended September 30, 2013 and 2012 were \$502,000 and \$546,000, respectively. For the three months ended September 30, 2013, and 2012, 401(k) expenses were \$160,000 and \$188,000, respectively.

The Company also maintains a Director Deferred Compensation Plan ("Deferred Compensation Plan"). This plan provides that any non-employee director of the Company or the Bank may elect to defer receipt of all or any portion of his or her compensation as a director. A participating director may elect to have amounts deferred under the Deferred Compensation Plan held in a deferred cash account, which is credited on a quarterly basis with interest equal to the highest rate offered by the Bank at the end of the preceding quarter. Alternatively, a participant may elect to have a deferred stock account in which deferred amounts are treated as if invested in the Company's common stock at the fair market value on the date of deferral. The value of a stock account will increase and decrease based upon the fair market value of an equivalent number of shares of common stock. In addition, the deferred amounts deemed invested in common stock will be credited with dividends on an equivalent number of shares. Amounts considered invested in the Company's common stock are paid, at the election of the director, either in cash or in whole shares of the common stock and cash in lieu of fractional shares. Directors may elect to receive amounts contributed to their respective accounts in one or up to five installments. There are no directors currently participating in the Deferred Compensation Plan.

The Company has a nonqualified deferred compensation plan for a former key employee's retirement, in which the contribution expense is solely funded by the Company. The retirement benefit to be provided is variable based upon the performance of underlying life insurance policy assets. Deferred compensation expense amounted to \$25,000 for the nine months ended September 30, 2013 and 2012. For the three months ended September 30, 2013 and 2012, deferred compensation expense was \$9,000 and \$8,000, respectively.

Concurrent with the establishment of the deferred compensation plan for the former employee, the Company purchased life insurance policies on this employee with the Company named as owner and beneficiary. These life insurance policies are intended to be utilized as a source of funding the Deferred Compensation Plan. Income on these life insurance policies amounted to \$22,000 and \$26,000 for the nine months ended September 30, 2013 and 2012, respectively. For the three months ended September 30, 2013 and 2012, income amounted to \$8,000 and \$9,000. The Company has recorded other assets of \$1.2 million representing cash surrender value of these policies at both September 30, 2013 and December 31, 2012.

Notes to Consolidated Financial Statements

Note 9. Fair Value Measurement

The Company follows ASC 820 "Fair Value Measurement and Disclosures" 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.

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 (Level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any market activity then the security would fall to the lowest level of the hierarchy (Level 3). The Company's investment portfolio is primarily valued using fair value measurements that are considered to be Level 2. The Company has contracted with a third party portfolio accounting service vendor for valuation of its securities based on market data. IDC utilizes evaluated pricing models that vary by asset class and include available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary models, vast descriptive terms and conditions databases, as well as extensive quality control programs. The carrying value of restricted Federal Reserve Bank of Richmond, Community Bankers Bank and Federal Home Loan Bank of Atlanta ("FHLB") stock approximates fair value based on the redemption provisions of each entity and are therefore excluded from the following table.

**Interest rate swaps:** Interest rate swaps are recorded at fair value on a recurring basis. The Company utilizes interest rate swap agreements as part of the management of interest rate risk to modify the repricing characteristics of certain portions of the Company's interest-bearing assets and liabilities. The Company has contracted with a third party to provide valuations for interest rate swaps using standard valuation techniques and therefore classifies such valuation as Level 2. The Company has considered counterparty credit risk in the valuation of its interest rate swap assets and has considered its own credit risk in the valuation of its interest rate swap liabilities.

## Notes to Consolidated Financial Statements

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012 by levels within the valuation hierarchy:

(In thousands)	Balance	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets at September 30, 2013:</b>				
Available-for-sale securities:				
Obligations of U.S. Government corporations and agencies	\$42,230	\$ -	\$ 42,230	\$ -
Obligations of states and political subdivisions	7,078	-	7,078	-
Corporate bonds	440	-	-	440
Mutual funds	352	352	-	-
Total available-for sale securities	\$50,100	\$ 352	\$ 49,308	\$ 440
Interest rate swaps	\$54	\$ -	\$ 54	\$ -
Total assets at fair value	\$50,154	\$ 352	\$ 49,362	\$ 440
<b>Liabilities at September 30, 2013:</b>				
Interest rate swaps	\$345	\$ -	\$ 345	\$ -
Total liabilities at fair value	\$345	\$ -	\$ 345	\$ -
<b>Assets at December 31, 2012:</b>				
Available-for-sale securities:				
Obligations of U.S. Government corporations and agencies	\$40,014	\$ -	\$ 40,014	\$ -
Obligations of states and political subdivisions	7,390	-	7,390	-
Corporate bonds	325	-	-	325
Mutual funds	363	363	-	-
Total available-for sale securities	\$48,092	\$ 363	\$ 47,404	\$ 325
Interest rate swaps	\$-	\$ -	\$ -	\$ -
Total assets at fair value	\$48,092	\$ 363	\$ 47,404	\$ 325
<b>Liabilities at December 31, 2012:</b>				
Interest rate swaps	\$841	\$ -	\$ 841	\$ -
Total liabilities at fair value	\$841	\$ -	\$ 841	\$ -

## Change in Level 3 Fair Value

The changes in Level 3 assets measured at estimated fair value on a recurring basis during the nine months ended September 30, 2013 and year ended December 31, 2012 were as follows:

(In thousands)	Total Gains (Losses) Realized/Unrealized			
	Balance included in	Included in Other	Transfers in	Balance

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	January 1, 2013	Earnings	Comprehensive Income	and/or out of Level 3 and 2	September 30, 2013
Available-for-sale securities	\$ 325	\$ -	\$ 115	\$ -	\$ 440

	Total Gains (Losses) Realized/Unrealized				
	Balance January 1, 2012	Included in Earnings	Included in Other Comprehensive Income	Transfers in and/or out of Level 3 and 2	Balance December 31, 2012
(In thousands)					
Available-for-sale securities	\$ 335	\$ -	\$ (10)	\$ -	\$ 325

Certain assets are measured at fair value on a nonrecurring basis in accordance with U.S. 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.

## Notes to Consolidated Financial Statements

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:

**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 securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal, of one year or less, 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 more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, of one year or less, 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 receivable 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. At September 30, 2013, the Company's Level 3 loans for which a reserve has been taken, consisted of three loans totaling \$330,000 secured by business assets and inventory with a reserve of \$219,000, and two loans totaling \$461,000 secured by real estate with a reserve of \$315,000.

**Other Real Estate Owned ("OREO"):** Foreclosed assets are adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair market value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company considers the OREO as nonrecurring Level 2. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers records the OREO as nonrecurring Level 3. Total valuation of OREO property was \$1.4 million at both September 30, 2013 and December 31, 2012.

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 September 30, 2013			
	Quoted Prices in Active Markets			
	Balance for as of September 30, 2013	Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets:				
Impaired loans, net	\$4,690	\$ -	\$ 4,433	\$ 257
Other real estate owned, net	1,406	-	1,406	-

Carrying Value at December 31, 2012

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	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets:				
Impaired loans, net	\$ 868	\$ -	\$ 491	\$ 377
Other real estate owned, net	1,406	-	1,406	-

The following table displays quantitative information about Level 3 Fair Value Measurements at September 30, 2013.

(In thousands)	Quantitative Information about Level 3 Fair Value Measurements			
	Fair Value	Valuation Technique(s)	Unobservable Input	Range
Corporate securities available for sale	\$ 440	Discounted cash flows	Prepayment rate, probability of default and loss severity	5.1% to 52.4% discount rate
Impaired loans	257	Appraised values	Age of appraisal, current market conditions, and experience within local market	0% to 100% discount
Total	\$ 697			



#### Notes to Consolidated Financial Statements

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 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 with a maturity of three months or less approximate fair value. Instruments with maturities of greater than three months are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar instruments.

#### 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.

#### Loans Receivable

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.

#### Life Insurance

The carrying amount of life insurance contracts is assumed to be a reasonable fair value. Life insurance contracts are carried on the balance sheet at their redemption value. This redemption value is based on existing market conditions and therefore represents the fair value of the contract.

#### Interest Rate Swaps

The fair values are based on quoted market prices or mathematical models using current and historical data.

#### 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 approximate fair value.

#### Borrowed Funds

The fair values of the Company's FHLB advances and other borrowings 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 creditworthiness 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 values of standby letters of credit are based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

At September 30, 2013 and December 31, 2012, the fair values of loan commitments and standby letters of credit were deemed immaterial.

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Notes to Consolidated Financial Statements

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

(In thousands)	Fair Value Measurements at September 30, 2013				
	Carrying Value of September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Fair Value as of September 30, 2013
<b>Assets</b>					
Cash and short-term investments	\$53,660	\$53,672	\$ -	\$ -	\$53,672
Securities available for sale	50,100	352	49,308	440	50,100
Restricted investments	1,462	-	1,462	-	1,462
Net loans	448,524	-	446,990	257	447,247
Accrued interest receivable	1,386	-	1,386	-	1,386
Interest rate swaps	54	-	54	-	54
BOLI	12,335	-	12,335	-	12,335
Total financial assets	\$567,521	\$54,024	\$511,535	\$697	\$566,256
<b>Liabilities</b>					
Deposits	\$522,803	\$-	\$524,356	\$-	\$524,356
Borrowings	13,155	-	13,040	-	13,040
Company obligated mandatorily redeemable capital securities	4,124	-	4,114	-	4,114
Accrued interest payable	223	-	223	-	223
Interest rate swaps	345	-	345	-	345
Total financial liabilities	\$540,650	\$-	\$542,078	\$-	\$542,078

(In thousands)	Fair Value Measurements at December 31, 2012				
	Carrying Value of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Fair Value as of December 31, 2012
<b>Assets</b>					
Cash and short-term investments	\$64,435	\$64,465	\$ -	\$ -	\$64,465
Securities available for sale	48,092	363	47,404	325	48,092
Restricted investments	2,337	-	2,337	-	2,337
Net Loans	445,108	-	443,045	377	443,422
Accrued interest receivable	1,283	-	1,283	-	1,283

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Interest rate swaps	-	-	-	-	-
BOLI	12,038	-	12,038	-	12,038
Total financial assets	\$573,293	\$64,828	\$506,107	\$702	\$571,637
Liabilities					
Deposits	\$515,134	\$-	\$517,811	\$-	\$517,811
Borrowings	28,200	-	28,877	-	28,877
Company obligated mandatorily redeemable capital securities	4,124	-	5,258	-	5,258
Accrued interest payable	312	-	312	-	312
Interest rate swaps	841	-	841	-	841
Total financial liabilities	\$548,611	\$-	\$553,099	\$-	\$553,099

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.

Notes to Consolidated Financial Statements

Note 10. Accumulated Other Comprehensive Income

Changes in Accumulated Other Comprehensive Income by Component (1)

(In thousands)	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Supplemental Executive Retirement Plans	Total
Balance December 31, 2012	\$ (361 )	\$ (1,398 )	\$ 47	\$(1,712)
Other comprehensive income (loss) before reclassifications	166	(732)	-	(566 )
Amounts reclassified from accumulated other comprehensive income	-	-	-	-
Net current-period other comprehensive income	166	(732)	-	(566 )
Balance September 30, 2013	\$ (195 )	\$ (2,130 )	\$ 47	\$(2,278)
Balance December 31, 2011	\$ (180 )	\$ (1,376 )	\$ 239	\$(1,317)
Other comprehensive income (loss) before reclassifications	(419 )	244	-	(175 )
Amounts reclassified from accumulated other comprehensive income	-	(109)	-	(109 )
Net current-period other comprehensive income	(419 )	135	-	(284 )
Balance September 30, 2012	\$ (599 )	\$ (1,241 )	\$ 239	\$(1,601)

(1) All amounts are net of tax. Amounts in parentheses indicate debits.

Reclassifications Out of Accumulated Other Comprehensive Income

(In thousands)	For the Three Months Ended September 30, 2013 2012		
Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where net income is presented.
Unrealized gains and losses on available-for sale securities	\$ -	\$ 2	Gain on sale of securities
	-	2	Total income before income tax
	-	1	Income tax expense
	\$ -	\$ 1	Net of tax

(In thousands)	For the Nine Months Ended September 30,		Affected line item in the statement where net income is presented.
	2013	2012	
Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income	Amount reclassified from accumulated other comprehensive income	
Unrealized gains and losses on available-for sale securities	\$ -	\$ 165	Gain on sale of securities
	-	165	Total income before income tax
	-	56	Income tax expense
	\$ -	\$ 109	Net of tax

## 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 Fauquier Bankshares, Inc. ("the Company"), 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.

### GENERAL

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 3,713,342 shares of common stock, par value \$3.13 per share, held by approximately 383 holders of record on September 30, 2013. 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. An eleventh branch office is currently projected to open in Gainesville, Virginia during early 2014. 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: interest bearing and non-interest-bearing demand deposit accounts, money market deposit accounts, NOW accounts, time deposits, safe deposit services, ATM, debit and credit cards, cash management, direct deposits, notary services, night depository, prepaid debit cards, cashier's checks, domestic and international collections, savings bonds, automated teller services, drive-in tellers, mobile and 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 Maestro, Accel 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") and Insured Cash Sweep Service ("ICS"), to provide customers multi-million dollar FDIC insurance on CD investments and deposit sweeps through the transfer and/or exchange with other FDIC insured institutions. CDARS and ICS are

registered service marks 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, Bankers Title Shenandoah, LLC, a title insurance company, and Infinex Investments, Inc., a full service broker/dealer. Bankers Insurance and Bankers Title Shenandoah are owned by a consortium of Virginia community banks, and Infinex is owned by banks and banking associations in various states.

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.

As of September 30, 2013, the Company had total consolidated assets of \$595.4 million, total loans net of allowance for loan losses of \$448.5 million, total consolidated deposits of \$522.8 million, and total consolidated shareholders' equity of \$48.9 million.

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## 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 three basic components: the specific allowance, the general allowance and the unallocated component. 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 identified as impaired. The specific allowance uses various techniques to arrive at an estimate of loss. 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. 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 identified as impaired. The general allowance begins with estimates of probable losses inherent in the homogeneous portfolio based upon various statistical analyses. These include analysis of historical 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. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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, 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 eight 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. 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 \$1.16 million for the third quarter of 2013 was a 4.0% decrease from the net income for the third quarter of 2012 of \$1.21 million. Net income of \$2.93 million for the nine months ended September 30, 2013 was a 30.5% increase from the net income of \$2.25 million for the nine months ended September 30, 2012 million. Loans, net of reserve, totaling \$448.5 million at September 30, 2013, increased 0.8% when compared with December 31, 2012, and increased 0.7% when compared with September 30, 2012. Deposits, totaling \$522.8 million at September 30, 2013, increased 1.5% compared with December 31, 2012, and increased 6.3% when compared with September 30, 2012. Assets under WMS management, totaling \$375.4 million in market value at September 30, 2013, increased 17.1% from September 30, 2012.

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 increase 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 current absolute level of historically low market interest rates, as well as the current slowness of new loan production, is also projected to result in a decrease in net interest income.

The Bank's non-performing assets totaled \$6.6 million or 1.11% of total assets at September 30, 2013, as compared with \$12.4 million or 2.06% of total assets at December 31, 2012, and \$14.5 million or 2.52% of total assets at September 30, 2012. Nonaccrual loans totaled \$5.1 million or 1.11% of total loans at September 30, 2013 compared with \$10.7 million or 2.36% of total loans at December 31, 2012, and \$12.4 million or 2.74% of total loans at September 30, 2012. The provision for loan losses was \$1.30 million for the first nine months of 2013 compared with \$3.85 million for the first nine months of 2012. The \$2.55 million decrease in the provision for loan losses was primarily due to reduction in nonperforming loans since December 31, 2012. During the first nine months ended September 30, 2013, there were net charge-offs of \$1.08 million or 0.24% of total average loans compared with \$1.97 million or 0.43% of total average loans for the same nine months of 2012. Total allowance for loan losses was \$6.5 million or 1.42% of total loans at September 30, 2013 compared with \$6.3 million or 1.39% of loans at December 31, 2012 and \$8.6 million or 1.90% of loans at September 30, 2012.

## COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

### NET INCOME

Net income of \$1.16 million for the quarter ended September 30, 2013 was a 4.0% decrease from the net income for the quarter ended September 30, 2012 of \$1.21 million. Earnings per share on a fully diluted basis were \$0.31 for the third quarter of 2013 compared with \$0.33 for the third quarter of 2012. Profitability as measured by return on average assets decreased from 0.83% in the third quarter of 2012 to 0.78% for the same period in 2013. Profitability as measured by return on average equity decreased from 10.00% to 9.51% over the same respective quarters in 2012 and 2013. The decrease in net income was primarily due to the \$285,000 increase in other expenses and the \$159,000 decrease in net interest income in the third quarter of 2013 compared with the third quarter of 2012, partially offset by the \$217,000 decrease in the provision for loan losses and the \$145,000 increase in other income over the same periods.

#### NET INTEREST INCOME AND EXPENSE

Net interest income decreased \$159,000 or 3.0% to \$5.15 million for the quarter ended September 30, 2013 from \$5.31 million for the quarter ended September 30, 2012. The decrease in net interest income was due primarily to the decline in loan and security balances and reduced yields on loans. This was partially offset by reduced rates on deposits and FHLB borrowings over the same period. The Company's net interest margin decreased from 3.94% in the third quarter of 2012 to 3.76% in the third quarter of 2013.

Total interest income decreased \$447,000 or 7.1% to \$5.84 million for the third quarter of 2013 from \$6.29 million for the third quarter of 2012. This decrease was primarily due to the decline in average loan and investment balances, as well as the decline in the yield on earning assets from 4.65% during the third quarter of 2012 to 4.25% during the third quarter of 2013.

The tax-equivalent average yield on loans was 4.85% for the third quarter of 2013, down from 5.22% in the third quarter of 2012. Average loan balances decreased \$3.9 million or 0.9% from \$456.0 million during the third quarter of 2012 to \$452.0 million during the third quarter of 2013. The decrease in balances and yield resulted in a \$452,000 or 7.6% decline in interest and fee income from loans for the third quarter of 2013, compared with the same period in 2012. On a tax equivalent basis, the decrease was \$459,000 or 7.7%.

Average investment security balances decreased \$8.2 million from \$58.2 million in the third quarter of 2012 to \$50.0 million in the third quarter of 2013. The tax-equivalent average yield on investments increased from 2.42% for the third quarter of 2012 to 2.75% for the third quarter of 2013. Interest and dividend income on security investments decreased \$7,000 or 2.2%, from \$320,000 for the third quarter of 2012 to \$313,000 for the third quarter of 2013. Interest income on deposits in other banks increased \$12,000 from third quarter 2012 to third quarter 2013 resulting from higher earning balances at the Federal Reserve.

Total interest expense decreased \$288,000 or 29.5% from \$977,000 for the third quarter of 2012 to \$689,000 for the third quarter of 2013 primarily due to the decline in interest paid on time deposits and FHLB of Atlanta advances.

Interest paid on deposits decreased \$137,000 or 19.8% from \$693,000 for the third quarter of 2012 to \$556,000 for the third quarter of 2013. Average balances on time deposits declined \$19.8 million or 14.3% from \$138.0 million to \$118.2 million while the average rate decreased from 1.55% in the third quarter of 2012 to 1.37% in the third quarter of 2013, resulting in \$130,000 less interest expense. Average money market account balances were approximately the same in the third quarter of 2012 and the third quarter of 2013 while the rate increased from 0.17% to 0.18%, resulting in \$1,000 more interest expense. Average savings account balances increased \$11.3 million or 17.5% from the third quarter of 2012 to the third quarter of 2013, while the average rate declined from 0.16% to 0.11%, resulting in a decrease of \$5,000 of interest expense for the third quarter of 2013. Average interest bearing checking balances increased \$24.7 million or 14.6% from the third quarter of 2012 to the third quarter of 2013, while the average rate decreased from 0.26% to 0.22%, resulting in a decrease of \$3,000 in interest checking expense for the third quarter of 2013.

From the third quarter of 2012 to the third quarter of 2013, interest expense on FHLB of Atlanta advances decreased \$151,000 or 64.5% due to a decrease in average balances from \$25.0 million during the three months ended September 30, 2012 to \$13.2 million during the three months ended September 30, 2013, while the average rate paid declined from 3.72% to 2.49% over the same time periods. Interest expense on capital securities was \$50,000 for the third quarter of 2012 and the third quarter of 2013.

The average rate on total interest-bearing liabilities decreased from 0.87% in the third quarter of 2012 to 0.61% for the third quarter of 2013.

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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 Expense, and Average Yields and Rates

(Dollars in thousands)	Three Months Ended September 30, 2013				Three Months Ended September 30, 2012			
	Average Balances	Income/ Expense	Average Rate		Average Balances	Income/ Expense	Average Rate	
<b>Assets</b>								
<b>Loans</b>								
Taxable	\$438,717	\$ 5,415	4.90	%	\$440,911	\$ 5,854	5.28	%
Tax-exempt (1)	7,131	114	6.33	%	8,110	134	6.59	%
Nonaccrual (2)	6,200	-			6,954	-		
Total Loans	452,048	5,529	4.85	%	455,975	5,988	5.22	%
<b>Securities</b>								
Taxable	43,471	251	2.31	%	51,300	258	2.02	%
Tax-exempt (1)	6,544	93	5.69	%	6,896	93	5.40	%
Total securities	50,015	344	2.75	%	58,196	351	2.42	%
<b>Deposits in banks</b>	49,978	38	0.30	%	30,348	26	0.34	%
Federal funds sold	9	-	0.12	%	12	-	0.18	%
Total earning assets	552,050	\$ 5,911	4.25	%	544,531	\$ 6,365	4.65	%
Less: Reserve for loan losses	(7,021 )				(9,581 )			
Cash and due from banks	5,077				5,054			
Bank premises and equipment, net	14,949				15,237			
Other real estate owned	1,406				1,776			
Other assets	25,786				23,675			
Total Assets	\$592,247				\$580,692			
<b>Liabilities and Shareholders' Equity</b>								
<b>Deposits</b>								
Demand deposits	\$87,853				\$81,718			
<b>Interest-bearing deposits</b>								
Checking accounts	194,448	\$ 107	0.22	%	169,702	\$ 110	0.26	%
Money market accounts	43,584	20	0.18	%	43,628	19	0.17	%
Savings accounts	75,874	21	0.11	%	64,572	26	0.16	%
Time deposits	118,230	408	1.37	%	138,036	538	1.55	%
Total interest-bearing deposits	432,136	556	0.51	%	415,938	693	0.66	%
Federal funds purchased	-	-	-		4	-	0.74	%
Federal Home Loan Bank advances	13,162	83	2.49	%	25,000	234	3.72	%
Capital securities of subsidiary trust	4,124	50	4.83	%	4,124	50	4.84	%
Total interest-bearing liabilities	449,422	689	0.61	%	445,066	977	0.87	%
Other liabilities	6,443				5,680			
Shareholders' equity	48,529				48,228			

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Total Liabilities & Shareholders' Equity	\$592,247			\$580,692		
Net interest spread	\$ 5,222	3.64	%	\$ 5,388	3.78	%
Interest expense as a percent of average earning assets		0.50	%		0.71	%
Net interest margin		3.76	%		3.94	%

- (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.

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## 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.

(In thousands)	Three Months Ended September 30, 2013		
	Compared to Three Months Ended September 30, 2012		
	Change	Due to Volume	Due to Rate
Interest Income			
Loans; taxable	\$(439)	\$ (30 )	\$(409)
Loans; tax-exempt (1)	(20 )	(16 )	(4 )
Securities; taxable	(7 )	(38 )	31
Securities; tax-exempt (1)	-	(5 )	5
Deposits in banks	12	16	(4 )
Federal funds sold	-	-	-
Total Interest Income	\$(454)	\$ (73 )	\$(381)
Interest Expense			
Checking accounts		\$(3 )	\$17
Money market accounts		1	0
Savings accounts		(5 )	4
Time deposits		(130)	(78 )
Federal funds purchased and securities sold under agreements to repurchase		-	-
Federal Home Loan Bank advances		(151)	(110)
Capital securities of subsidiary trust		-	-
Total Interest Expense		(288)	(167)
Net Interest Income		\$(166)	\$94
			\$(260)

(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

The provision for loan losses was \$333,000 for the third quarter of 2013 compared with \$550,000 for the third quarter of 2012. 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. The \$217,000 decrease in the provision for loan losses was primarily due to reduction in nonperforming loans.

## OTHER INCOME



Total other income increased by \$145,000 or 9.4% from \$1.54 million for the third quarter of 2012 to \$1.69 million in the third quarter of 2013. Non-interest income is derived primarily from recurring non-interest fee income, which consists primarily of fiduciary trust and other Wealth Management fees, brokerage fees, service charges on deposit accounts, debit card interchange income and other fee income. The increase was primarily due to a \$101,000 increase in service charges on deposit accounts during the third quarter of 2013 compared with the third quarter of 2012.

Trust and estate income increased \$28,000 or 8.3% from the third quarter of 2012 to the third quarter of 2013 primarily due to increased revenues on managed investment accounts.

Brokerage service revenues increased \$8,000 or 10.7% from the third quarter of 2012 to the third quarter of 2013 due to higher volumes of products sold.

Service charges on deposit accounts increased \$101,000 or 15.2% to \$765,000 for the third quarter of 2013 compared to one year earlier. The change is primarily due to an increase in the number of checking accounts at the bank, as well as fee structure changes based on a competitive market analysis.

Other service charges, commissions and fees increased \$10,000 or 2.1% from \$467,000 in third quarter of 2012 to \$477,000 in the third quarter of 2013. Included in other service charges, commissions, and income is debit card interchange income which totaled \$322,000 and \$304,000 for the third quarters of 2013 and 2012, respectively. Also included is Bank Owned Life Insurance ("BOLI") income, which was \$97,000 during the third quarter of 2013, compared with \$103,000 one year earlier. Total BOLI was \$12.3 million in cash value at September 30, 2013, compared with \$11.9 million one year earlier.

#### OTHER EXPENSE

Total other expense increased \$285,000 or 6.1% during the third quarter of 2013 compared with the third quarter of 2012, primarily due to the increase in other operating expenses.

Salaries and employees' benefits decreased \$58,000 or 2.5% from third quarter 2012 to third quarter 2013. The decrease was primarily due to the reduction of full-time equivalent employees for the third quarter of 2013 compared with the third quarter of 2012. Active full-time equivalent employees were reduced from 143.3 as of September 30, 2012 to 140.5 as of September 30, 2013. At September 30, 2013, the Company had approximately twelve full-time equivalent positions to be filled.

Occupancy expense increased \$8,000 or 1.7%, while furniture and equipment expense decreased \$34,000 or 12.0%, from third quarter 2012 to third quarter 2013 primarily due to reduced depreciation on technology equipment.

Marketing expense decreased \$40,000 or 19.8% from the third quarter of 2012 to \$162,000 for the third quarter of 2013. The decrease in marketing expense is primarily related to a reduction in expenses for newspaper and other media advertising.

Legal, accounting and consulting expense increased \$53,000 or 20.3% from the third quarter of 2012 to \$314,000 for the third quarter of 2013 primarily due to consulting expenses associated with compensation practices.

Data processing expense increased \$55,000 or 18.7% for the third quarter of 2013 compared with the same time period in 2012 due to the growth in customer accounts and transactions processed. The Bank outsources much of its data processing to third-party vendors.

FDIC deposit insurance expense decreased \$1,000 from \$121,000 for the third quarter of 2012 to \$120,000 for the third quarter of 2013.

Other operating expenses increased \$310,000 or 49.4% in the third quarter of 2013 compared with the third quarter of 2012. The increase was primarily due to \$160,000 reserved for an unfunded letter of credit commitment in the third quarter of 2013, as well as increased expenses related to deposit-related charge-offs.

#### INCOME TAXES

Income tax expense was \$418,000 for the quarter ended September 30, 2013 compared with \$452,000 for the quarter ended September 30, 2012. The effective tax rate was 26.4% and 27.2% for the third quarter of 2013 and 2012, respectively. The effective tax rate differed from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, income from the BOLI purchases, and community development tax credits.

## COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

## NET INCOME

Net income of \$2.93 million for the nine months ended September 30, 2013 was a 30.5% increase from the net income for the nine months ended September 30, 2012 of \$2.25 million. Earnings per share on a fully diluted basis were \$0.79 for the nine months ended September 30, 2013 compared with \$0.61 for the nine months ended September 30, 2012. Profitability as measured by return on average assets increased from 0.51% in the nine months ended September 30, 2012 to 0.66% for the same period in 2013. Profitability as measured by return on average equity increased from 6.22% to 8.10% over the same respective quarters in 2012 and 2013. The increase in net income was primarily due to the \$2.55 million reduction in the provision for loan losses for the nine months ended September 30, 2013 compared with the nine months ended September 30, 2012, partially offset by the \$1,110,000 decrease in net interest income and \$495,000 increase in total other expenses over the same time periods.

## NET INTEREST INCOME AND EXPENSE

Net interest income decreased \$1.11 million or 6.9% to \$14.92 million for the nine months ended September 30, 2013 from \$16.03 million for the nine months ended September 30, 2012. The decrease in net interest income was due primarily to the decline in loan and security balances, increase in average nonaccrual loans, and reduced yields on earning assets. This was partially offset by reduced rates on deposits over the same period. The Company's net interest margin decreased from 3.93% in the nine months ended September 30, 2012 to 3.65% in the nine months ended September 30, 2013.

Total interest income decreased \$1.85 million or 9.7% to \$17.31 million for the nine months ended September 30, 2013 from \$19.16 million for the nine months ended September 30, 2012. This decrease was primarily due to reduced loan and security balances and a 46 basis point decline in the yield on earning assets from nine months ended September 30, 2012 to the nine months ended September 30, 2013.

The tax-equivalent average yield on loans was 4.88% for the nine months ended September 30, 2013, down from 5.32% in the nine months ended September 30, 2012. Average loan balances decreased \$7.3 million or 1.6% to \$449.7 million during the nine months ended September 30, 2013 from \$457.0 million during the nine months ended September 30, 2012. The decrease in balances and yield resulted in a \$1.75 million or 9.7% decline in interest and fee income from loans for the nine months ended September 30, 2013 compared with the same period in 2012. On a tax equivalent basis, the decrease was \$1.78 million or 9.8%.

Average investment security balances decreased \$8.6 million from \$58.3 million in the nine months ended September 30, 2012 to \$49.7 million in the nine months ended September 30, 2013. The tax-equivalent average yield on investments increased from 2.56% for the nine months ended September 30, 2012 to 2.64% for the nine months ended September 30, 2013. Interest and dividend income on security investments decreased \$138,000 or 13.5%, from \$1.03 million for the nine months ended September 30, 2012 to \$887,000 for the nine months ended September 30, 2013. Interest income on deposits in other banks increased \$35,000 from nine months ended September 30, 2012 to nine months ended September 30, 2013 resulting from higher earning balances at the Federal Reserve.

Total interest expense decreased \$740,000 or 23.60% from \$3.13 million for the nine months ended September 30, 2012 to \$2.39 million for the nine months ended September 30, 2013, primarily due to the decline in interest paid on time deposits and FHLB of Atlanta advances.

Interest paid on deposits decreased \$541,000 or 23.90% from \$2.26 million for the nine months ended September 30, 2012 to \$1.72 million for the nine months ended September 30, 2013. Average balances on time deposits declined \$23.6 million or 16.0% from \$147.3 million to \$123.6 million while the average rate decreased from 1.58% to 1.38% in the nine months ended September 30, 2012 to the nine months ended September 30, 2013, resulting in \$465,000 less interest expense. Average money market accounts decreased \$480,000 or 1.1% from the nine months ended

September 30, 2012 to the nine months ended September 30, 2013 while the rate declined from 0.20% to 0.18%, resulting in \$9,000 less interest expense. Average savings account balances increased \$7.7 million from the nine months ended September 30, 2012 to the nine months ended September 30, 2013, while their average rate was 0.16% and 0.13% over the same respective periods, resulting in a decrease of \$8,000 of interest expense for the nine months ended September 30, 2013. Average NOW deposit balances increased \$16.7 million from the nine months ended September 30, 2012 to the nine months ended September 30, 2013, while the average rate decreased from 0.29% to 0.22%, resulting in a decrease of \$59,000 in checking interest expense for the nine months ended September 30, 2013.

From the nine months ended September 30, 2012 to the nine months ended September 30, 2013, interest expense on FHLB of Atlanta advances decreased \$198,000 due to a decrease in average balances of \$3.4 million and the average rate of 61 basis points over the same respective time periods. Interest expense on capital securities was \$150,000 and \$149,000 for the nine months ended September 30, 2012 and 2013, respectively.

The average rate on total interest-bearing liabilities decreased from 0.92% in the nine months ended September 30, 2012 to 0.71% for the nine months ended September 30, 2013.

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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 Expense, and Average Yields and Rates

(Dollars in thousands)	Nine Months Ended September 30, 2013			Nine Months Ended September 30, 2012				
	Average Balances	Income/ Expense	Average Rate	Average Balances	Income/ Expense	Average Rate		
<b>Assets</b>								
<b>Loans</b>								
Taxable	\$433,725	\$16,074	4.96 %	\$442,708	\$17,766	5.36 %		
Tax-exempt (1)	7,218	342	6.34 %	8,723	425	6.50 %		
Nonaccrual (2)	8,754	-	-	5,568	-	-		
Total Loans	449,697	16,416	4.88 %	456,999	18,191	5.32 %		
<b>Securities</b>								
Taxable	42,997	703	2.18 %	51,409	840	2.18 %		
Tax-exempt (1)	6,729	280	5.54 %	6,894	279	5.41 %		
Total securities	49,726	983	2.64 %	58,303	1,119	2.56 %		
<b>Deposits in banks</b>								
Federal funds sold	54,668	123	0.30 %	37,344	88	0.32 %		
Total earning assets	10	-	0.15 %	10	-	0.20 %		
	554,101	\$17,522	4.23 %	552,656	\$19,398	4.69 %		
<b>Less: Reserve for loan losses</b>								
	(6,608 )			(7,860 )				
<b>Cash and due from banks</b>								
	5,072			4,996				
<b>Bank premises and equipment, net</b>								
	14,909			15,181				
<b>Other real estate owned</b>								
	1,406			1,776				
<b>Other assets</b>								
	25,762			23,587				
Total Assets	\$594,642			\$590,336				
<b>Liabilities and Shareholders' Equity</b>								
<b>Deposits</b>								
<b>Demand deposits</b>								
	\$86,170			\$79,307				
<b>Interest-bearing deposits</b>								
Checking accounts	188,248	\$317	0.22 %	171,510	\$376	0.29 %		
Money market accounts	43,794	58	0.18 %	44,274	67	0.20 %		
Savings accounts	71,926	69	0.13 %	64,247	77	0.16 %		
Time deposits	123,642	1,275	1.38 %	147,259	1,740	1.58 %		
Total interest-bearing deposits	427,610	1,719	0.54 %	427,290	2,260	0.71 %		
<b>Federal funds purchased</b>								
	2	-	0.69 %	7	-	0.76 %		
<b>Federal Home Loan Bank advances</b>								
	21,566	523	3.24 %	25,000	721	3.85 %		
<b>Capital securities of subsidiary trust</b>								
	4,124	149	4.83 %	4,124	150	4.85 %		
Total interest-bearing liabilities	453,302	2,391	0.71 %	456,421	3,131	0.92 %		

Other liabilities	6,802	6,346
Shareholders' equity	48,368	48,262
Total Liabilities & Shareholders' Equity	\$594,642	\$590,336

Net interest spread	\$ 15,131	3.52 %	\$ 16,267	3.77 %
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Interest expense as a percent of average earning

assets	0.58 %	0.76 %
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Net interest margin	3.65 %	3.93 %
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(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.

(In thousands)	Nine Months Ended September 30, 2013 Compared to Nine Months Ended September 30, 2012		
	Change	Due to Volume	Due to Rate
Interest Income			
Loans; taxable	\$ (1,692)	\$ (361 )	\$ (1,331)
Loans; tax-exempt (1)	(83 )	(73 )	(10 )
Securities; taxable	(137 )	(137 )	-
Securities; tax-exempt (1)	1	(7 )	8
Deposits in banks	35	41	(6 )
Federal funds sold	-	-	-
Total Interest Income	(1,876)	(537 )	(1,339)
Interest Expense			
Checking accounts	(59 )	37	(96 )
Money market accounts	(9 )	(1 )	(8 )
Savings accounts	(8 )	10	(18 )
Time deposits	(465 )	(279 )	(186 )
Federal funds purchased and securities sold under agreements to repurchase	-	-	-
Federal Home Loan Bank advances	(198 )	(99 )	(99 )
Capital securities of subsidiary trust	(1 )	-	(1 )
Total Interest Expense	(740 )	(332 )	(408 )
Net Interest Income	\$ (1,136)	\$ (205 )	\$ (931 )

(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

The provision for loan losses was \$1.30 million for the nine months ended September 30, 2013 compared with \$3.85 million for the nine months ended September 30, 2012. 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. The \$2.55 million decrease in the provision for loan losses was primarily due to reduction in nonperforming loans, partially offset by the need to add additional reserves on the remaining impaired hospitality loan.

#### OTHER INCOME

Total other income increased by \$77,000 or 1.6% from \$4.79 million for the nine months ended September 30, 2012 to \$4.87 million in the nine months ended September 30, 2013. Non-interest income is derived primarily from recurring non-interest fee income, which consists primarily of fiduciary trust and other Wealth Management fees, brokerage fees, service charges on deposit accounts, debit card interchange income and other fee income. The increase was primarily due to increases in brokerage income, service charges on deposits, and other service charges during the nine months ended September 30, 2013 compared with the nine months ended September 30, 2012, partially offset by a \$165,000 decline in the gain on sale of securities over the same time period.

Trust and estate income increased \$8,000 or 0.7% from the nine months ended September 30, 2012 to the nine months ended September 30, 2013.

Brokerage service revenues increased \$89,000 or 37.6% from the nine months ended September 30, 2012 to the nine months ended September 30, 2013 due to higher volumes of products sold.

Service charges on deposit accounts increased \$82,000 or 4.1% to \$2,092,000 for the nine months ended September 30, 2013 compared to one year earlier. The change is primarily due to an increase in the number of checking accounts at the Bank, as well as fee structure changes based on a competitive market analysis.

Other service charges, commissions and fees increased \$63,000 or 4.8% from \$1.30 million during the nine months ended September 30, 2012 to \$1.36 million during the nine months ended September 30, 2013. Included in other service charges, commissions, and income is ATM/debit card interchange income which totaled \$918,000 and \$873,000 for the first nine months of 2013 and 2012, respectively. Also included is BOLI income, which was \$297,000 during the nine months ended September 30, 2013, compared with \$313,000 one year earlier.

#### OTHER EXPENSE

Total other expense increased \$495,000 or 3.5% during the nine months ended September 30, 2013 compared with the nine months ended September 30, 2012. The increase was primarily due to \$160,000 reserved for an unfunded letter of credit commitment during the third quarter of 2013, as well as increased expenses related to deposit-related charge-offs.

Salaries and employees' benefits decreased \$9,000 or 0.1% from the nine months ended September 30, 2012 to the nine months ended September 30, 2013.

Occupancy expense increased \$24,000 or 1.7%, while furniture and equipment expense decreased \$92,000 or 10.6%, from the nine months ended September 30, 2012 to the nine months ended September 30, 2013 primarily due to reduced depreciation on technology equipment.

Marketing expense decreased \$70,000 or 13.4% from the nine months ended September 30, 2012 to \$452,000 for the nine months ended September 30, 2013. The decrease in marketing expense is primarily related to a reduction in expenses for media advertising and promotional items.

Legal, accounting and consulting expense increased \$159,000 or 20.1% from the nine months ended September 30, 2012 to \$952,000 for the nine months ended September 30, 2013 due to legal expenses associated with the management and disposition of problem hospitality loans, as well as consulting expense related to compensation practices.

Data processing expense increased \$84,000 or 9.2% for the nine months ended September 30, 2013 compared with the same time period in 2012 due to the growth in customer accounts and transactions processed. The Bank outsources much of its data processing to third-party vendors.



FDIC deposit insurance expense increased \$43,000 from \$345,000 for the nine months ended September 30, 2012 to \$388,000 for the nine months ended September 30, 2013 due to changes in the factors used to calculate FDIC expense.

Other operating expenses increased \$360,000 or 17.2% in the nine months ended September 30, 2013 compared with the nine months ended September 30, 2012. The increase was primarily due to \$160,000 reserved for an unfunded letter of credit commitment during the third quarter of 2013, as well as increased expenses related to deposit-related charge-offs.

#### INCOME TAXES

Income tax expense was \$964,000 for the nine months ended September 30, 2013 and \$627,000 for the nine months ended September 30, 2012. The effective tax rate was 24.8% and 21.8% for the first nine months of 2013 and 2012, respectively. The effective tax rate differed from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, income from the BOLI purchases, and community development tax credits.

COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2013 AND DECEMBER 31, 2012

Total assets were \$595.4 million at September 30, 2013 compared with \$601.4 million at December 31, 2012, a decrease of 1.0% or \$5.9 million. Balance sheet categories reflecting significant changes include interest-bearing deposits in other banks, loans, deposits, and FHLB advances. Each of these categories is discussed below.

**INTEREST-BEARING DEPOSITS IN OTHER BANKS.** Interest bearing deposits in other banks were \$48.5 million at September 30, 2013, a decrease of \$11.2 million from December 31, 2012. The reduction in this account is primarily due to using the funds for the repayment of FHLB advances totaling \$15.0 million.

**LOANS.** Loans, net of allowance for loan losses, were \$448.5 million at September 30, 2013, reflecting an increase of \$3.4 million from \$445.1 million at December 31, 2012. The increase is due to purchase of U.S. Government guaranteed student loans as part of the Federal Rehabilitated Student Loan Program which was partially offset by increased competition and a slow local economy for real estate lending. During the nine months ended September 30, 2013, the Bank purchased approximately \$19.0 million of student loans. For additional information regarding Federal Rehabilitated Student Loans, see "Loans and Allowance for Loan Losses" in Note 3 of the Notes to Consolidated Financial Statements contained herein.

**DEPOSITS.** For the nine months ended September 30, 2013, total deposits increased by \$7.7 million or 1.5% when compared with total deposits at December 31, 2012. Non-interest-bearing deposits increased by \$2.3 million and interest-bearing deposits increased by \$5.3 million. Included in interest-bearing deposits at September 30, 2013 and December 31, 2012 were \$15.0 million and \$26.0 million, respectively, of brokered deposits as defined by the Federal Reserve. Of the \$15.0 million in brokered deposits, \$10.6 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 increase in the Bank's non-interest-bearing deposits and interest-bearing deposits during the first nine months of 2013 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, the in-and-outflow of local government tax receipts, 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 during the remainder of 2013 and beyond through the expansion of its branch network, as well as by offering value-added interest checking and demand deposit products, and selective rate premiums on its interest-bearing deposits.

**FEDERAL HOME LOAN BANK ADVANCE.** FHLB advances decreased \$15.0 million to \$13.2 million at September 30, 2013 compared with December 31, 2012.

**ASSET QUALITY**

Non-performing assets primarily 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 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.

In accordance with ASC 855-10/SFAS 165 and discussed in Note 23: "Subsequent Events" in the Company's 2012 Annual Report on Form 10-K, two events subsequent to December 31, 2012 were recognized with respect to the audited financial statements for the year ended December 31, 2012. These events occurred subsequent to the Company's February 4, 2013 press release with respect to unaudited financial statements and fourth quarter 2012 earnings. The first event on March 14, 2013: the Company's Board of Directors approved a settlement on a large nonperforming commercial real estate/hospitality loan based on an updated appraisal received concurrently with a proposed settlement offer. This resulted in a \$607,000 addition to the provision for loan loss and an additional charge-off of \$1.0 million on the loan and a remaining loan balance of \$4.0 million. During the nine months ended September 30, 2013, the remaining \$4.0 million of this loan was paid off in full. The second event occurring during March 2013: the Company received an updated appraisal on an other real estate owned ("OREO") property which resulted in a \$370,000 addition to the reserve for OREO loss.

Non-performing assets totaled \$6.6 million or 1.11% of total assets at September 30, 2013, compared with \$12.4 million or 2.06% of total assets at December 31, 2012, and \$14.5 million or 2.52% of total assets at September 30, 2012. Included in non-performing assets at September 30, 2013 were \$128,000 of non-performing pooled trust preferred bonds at market value, \$1.4 million of OREO and \$5.1 million of non-accrual loans. Non-accrual loans as a percentage of total loans were 1.11% at September 30, 2013, as compared with 2.36% and 2.74% at December 31, 2012 and September 30, 2012, respectfully.

Student loans that were past due 90 days or more and still accruing interest totaled \$3.6 million at September 30, 2013 and zero at December 31, 2012 and September 30, 2012. These loans continue to accrue interest when past due because repayment of both principal and accrued interest are 98% guaranteed by the U.S. Department of Education.

Other loans that were past due 90 days or more and still accruing interest totaled \$1,000 at September 30, 2013, compared with \$132,000 on December 31, 2012 and \$248,000 at September 30, 2012. During the quarter ended September 30, 2013, there were two loans totaling \$1.8 million that were identified as Troubled Debt Restructurings ("TDRs"). At the end of the quarter, thirteen TDRs, totaling \$9.5 million, were in the loan portfolio. Nine of the loans, totaling \$8.6 million, were on accrual status and performing in accordance with the modified terms. The remaining four loans, totaling \$1.0, remained in nonaccrual status due to irregular payments. Appropriate specific reserves had been established. Restructured loans are included in the specific reserve calculation in the allowance for loan losses and are included in impaired loans.

For additional information regarding non-performing assets and potential loan problems, see "Loans and Allowance for Loan Losses" in Note 3 of the Notes to Consolidated Financial Statements contained herein.

At September 30, 2013, no concentration of loans and loan commitments to commercial borrowers engaged in similar activities exceeded 5% of total gross loans. The largest industry concentration of loans and loan commitments at September 30, 2013 was approximately \$13.8 million or 3.0% of loans to customers in the childcare industry. The second largest industry concentration of loans and loan commitments at September 30, 2013 was approximately \$12.0 million, or 2.6% of loans to customers in the hospitality industry (hotels, motels, inns, etc.) The deterioration of credit quality among hospitality loan relationships was the primary cause of the level of non-performing loans, loan charge-offs and the provision for loan losses during the fifteen months ended June 30, 2013.

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The following table sets forth certain credit information with respect to the Bank's hospitality loan portfolio, as well as reserve and charge-off activity, at the dates indicated. Please note that all hospitality loans are part of the commercial real estate loan segment as discussed throughout this report, in particular in Note 3 "Loans and Allowance for Loan Losses" of the Notes to Consolidated Financial Statements.

Hospitality Loans

(Dollars in thousands)	Outstanding Balance	Number of Loan Relationships	Reserve Allocation	U.S. Government Guarantee
At December 31, 2012:				
Pass	\$ 8,885	3	\$ 65	\$ -
Special mention	-	-	-	-
Substandard	7,230	2	-	2,358
Doubtful	-	-	-	-
Loss	-	-	-	-
Total hospitality loans	\$ 16,115	5	\$ 65	\$ 2,358

At September 30, 2013:				
Pass	\$ 9,302	3	\$ 67	\$ -
Special mention	-	-	-	-
Substandard	2,679	1	7	2,358
Doubtful	-	-	-	-
Loss	-	-	-	-
Total hospitality loans	\$ 11,981	4	\$ 74	\$ 2,358

At December 31, 2012:				
Not impaired	\$ 8,885	3	\$ 65	\$ -
Impaired	7,230	2	-	2,358
Total hospitality loans	\$ 16,115	5	\$ 65	\$ 2,358

At September 30, 2013:				
Not impaired	\$ 9,302	3	\$ 67	\$ -
Impaired	2,679	1	7	2,358
Total hospitality loans	\$ 11,981	4	\$ 74	\$ 2,358

At December 31, 2012:				
Performing	\$ 8,885	3	\$ 65	\$ -
Non-performing	7,230	2	-	2,358
Total hospitality loans	\$ 16,115	5	\$ 65	\$ 2,358

At September 30, 2013:				
Performing	\$ 9,302	3	\$ 67	\$ -
Non-performing	2,679	1	7	2,358
Total hospitality loans	\$ 11,981	4	\$ 74	\$ 2,358

Hospitality Loan Activity

(In thousands)	Outstanding Balance	Number of Loan Relationships	Reserve Allocation	U.S. Government Guarantees
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Balance at December 31, 2012:	\$ 16,115	5	\$ 65	\$ 2,358
Disbursements	616	-	-	-
Amortization/prepayments on performing	(200 )	-	-	-
Amortization/prepayments on non-performing	(4,000 )	(1 )	-	-
Charge-offs	(550 )	-	-	-
Provision for loan losses	-	-	9	-
Balance at September 30, 2013	\$ 11,981	4	\$ 74	\$ 2,358

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 commercial construction and land loans and (b) 300% for permanent investor commercial real estate loans. As of September 30, 2013, commercial construction and land loans were \$27.3 million or 47.1% of the concentration limit. Commercial investor real estate loans, including commercial construction and land loans, were \$129.5 million or 223.4% of the concentration guideline.

**CONTRACTUAL OBLIGATIONS**

As of September 30, 2013, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in "Management's Discussion and Analysis and Results of Operations" in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

**OFF-BALANCE SHEET ARRANGEMENTS**

As of September 30, 2013, there have been no material changes to the off-balance sheet arrangements disclosed in "Management's Discussion and Analysis and Results of Operations" in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

**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 September 30, 2013, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

At September 30, 2013 and December 31, 2012, the Company exceeded its regulatory capital ratios, as set forth in the following table:

**Risk Based Capital Ratios**

	September 30, 2013	December 31, 2012
(Dollars in thousands)		
Tier 1 Capital:		
Shareholders' Equity	\$ 48,885	\$ 47,748
Plus: Unrealized loss on securities available for sale, net	2,130	1,398
Less: Unrealized loss on equity securities, net	-	-
Plus: Accumulated net loss on hedges	148	314
Plus: Company-obligated mandatorily redeemable capital securities	4,000	4,000
Less: Disallowed deferred tax assets	(49 )	-
Total Tier 1 Capital	55,114	53,460
Tier 2 Capital:		
Allowable Allowance for Loan Losses	5,343	5,493
Total Capital:	\$ 60,457	\$ 58,953
Risk Weighted Assets:	\$ 426,307	\$ 438,705

## Regulatory Capital Ratios:

Leverage Ratio	9.31	%	9.12	%
Tier 1 to Risk Weighted Assets	12.93	%	12.19	%
Total Capital to Risk Weighted Assets	14.18	%	13.44	%

On July 2, 2013, the Federal Reserve Board adopted a final rule ("new rule") for the U. S. implementation of the Basel III accords for banking organizations. This new rule will result in higher minimum capital requirements that better reflect banking organizations' risk profiles, and establishes criteria that capital instruments must meet in order to be considered common equity tier 1 capital, additional tier 1 capital, or tier 2 capital. The minimum capital to risk-weighted assets requirements include: a new common equity tier 1 capital ratio of 4.50%; a revised tier 1 capital ratio of 6.00%, which is an increase from 4.00%, and the total capital ratio that remains at 8.00%. The minimum leverage ratio (tier 1 capital to total assets) is 4.00%. The new rule maintains the general structure of the current Prompt Corrective Action framework while incorporating these increased minimum requirements. The Bank is subject to the new rule on January 1, 2015, and management believes that the Bank will be fully compliant with the revised standards on the effective date.

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## CAPITAL RESOURCES AND LIQUIDITY

Shareholders' equity totaled \$48.9 million at September 30, 2013 compared with \$47.7 million at December 31, 2012 and \$48.5 million at September 30, 2012. The amount of equity reflects management's desire to increase shareholders' return on equity while maintaining a strong capital base. On January 17, 2013, the Company's Board of Directors authorized the Company to repurchase up to 110,855 shares (3% of common stock outstanding on January 1, 2013) beginning January 1, 2013 and continuing until the next Board reset. No shares were repurchased during the nine months ended September 30, 2013. Accumulated other comprehensive income/loss was an unrealized loss net of tax benefit of \$2.3 million at September 30, 2013 compared with an unrealized loss of \$1.7 million at December 31, 2012 and \$1.6 million at September 30, 2012.

As discussed in "Company-Obligated Mandatorily Redeemable Capital Securities" in Note 4 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 September 30, 2013, 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 of Richmond 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 \$53.7 million at September 30, 2013 compared with \$64.4 million at December 31, 2012. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available for sale, of which approximately \$6.1 million was unpledged and readily salable at September 30, 2013. Furthermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately \$124.3 million at September 30, 2013 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with the Federal Reserve and various other commercial banks totaling approximately \$57.5 million. At September 30, 2013, \$13.2 million of the FHLB of Atlanta line of credit and no 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 September 30, 2013 and December 31, 2012. 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)	September 30, 2013			December 31, 2012			
	Total	In Use	Available	Total	In Use	Available	
Sources:							
Federal funds borrowing lines of credit	\$57,487	\$-	\$57,487	\$69,692	\$-	\$69,692	
Federal Home Loan Bank advances	124,279	13,155	111,124	118,636	28,200	90,436	
Federal funds sold and interest-bearing deposits in other banks, excluding requirements			25,690			39,044	
Securities, available for sale and unpledged at fair value			6,056			5,917	
Total short-term funding sources			\$200,357			\$205,089	
Uses:							
Unfunded loan commitments and lending lines of credit			\$65,663			\$61,615	
Letters of credit			4,893			4,001	
Total potential short-term funding uses			\$70,556			\$65,616	
Ratio of short-term funding sources to potential short-term funding uses			2.8	%		3.1	%

## 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 U.S. GAAP, 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.

## CHANGES IN ACCOUNTING PRINCIPLES

For information regarding recent accounting pronouncements and their effect on the Company, see "Recent Accounting Pronouncements" in Note 1 of the Notes to Consolidated Financial Statements contained herein.

### 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, 2012.

### 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 SEC. 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.

The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. There have not been any significant changes in the Company's internal control over financial reporting or in other factors that have materially affected or are reasonably likely to materially affect, such controls during the quarter ended September 30, 2013.

### ITEM 1. LEGAL PROCEEDINGS

There is 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.

#### ITEM 1A. RISK FACTORS

Not applicable to smaller reporting companies.

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

On January 17, 2013, the Company's Board of Directors authorized the Company to repurchase up to 110,855 shares (3% of common stock outstanding on January 1, 2013) beginning January 1, 2013 and continuing until the next Board reset. No shares were repurchased during the three month period ended September 30, 2013.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

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Exhibit Exhibit  
Number 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 By-laws of Fauquier Bankshares, Inc., as amended and restated, incorporated by reference to Exhibit 3.2 to Form 10-Q filed August 9, 2010.
- 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.

- 101.00 The following materials from the Company's Form 10-Q Report for the quarterly period ended September 30, 2013, formatted in XBRL: (1) Consolidated Balance Sheets, (2) Consolidated Statements of Income, (3) Consolidated Statements of Comprehensive Income (4) Consolidated Statement of Changes in Shareholders' Equity, (5) Consolidated Statements of Cash Flows and (6) the Notes to Consolidated Financial Statements.

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: November 14, 2013

/s/ Eric P. Graap

Eric P. Graap  
Executive Vice President & Chief Financial Officer  
Dated: November 14, 2013