

FAUQUIER BANKSHARES, INC.  
Form 10-Q  
November 13, 2015  
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, 2015

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No.: 000-25805

Fauquier Bankshares, Inc.  
(Exact name of registrant as specified in its charter)

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 3,744,562 shares of common stock outstanding as of November 5, 2015.

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FAUQUIER BANKSHARES, INC.  
INDEX

Part I. FINANCIAL INFORMATION

	Page
Item 1. Financial Statements	2
Consolidated Balance Sheets as of September 30, 2015 (unaudited) and December 31, 2014	2
Consolidated Statements of Income (unaudited) for the Three Months Ended September 30, 2015 and 2014	3
Consolidated Statements of Income (unaudited) for the Nine Months Ended September 30, 2015 and 2014	4
Consolidated Statements of Comprehensive Income (unaudited) for the Three and Nine Months Ended September 30, 2015 and 2014	5
Consolidated Statements of Changes in Shareholders' Equity (unaudited) for the Nine Months Ended September 30, 2015 and 2014	6
Consolidated Statements of Cash Flows (unaudited) for the Nine Months Ended September 30, 2015 and 2014	7
Notes to Consolidated Financial Statements	8
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	30
Item 3. Quantitative and Qualitative Disclosures About Market Risk	48
Item 4. Controls and Procedures	48
Part II. OTHER INFORMATION	
Item 1. Legal Proceedings	48
Item 1A. Risk Factors	48
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	48
Item 3. Defaults Upon Senior Securities	48
Item 4. Mine Safety Disclosures	48

Item 5. Other Information	48
Item 6. Exhibits	49
SIGNATURES	50

## Part I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

	September 30, 2015 (Unaudited)	December 31, 2014 (Audited)
(In thousands, except share and per share data)		
Assets		
Cash and due from banks	\$ 5,615	\$ 6,831
Interest-bearing deposits in other banks	23,860	57,534
Federal funds sold	9	11
Securities available for sale	55,504	57,406
Restricted investments	1,286	1,294
Loans	465,481	440,461
Allowance for loan losses	(4,776 )	(5,391 )
Net loans	460,705	435,070
Bank premises and equipment, net	20,627	21,068
Accrued interest receivable	1,450	1,473
Other real estate owned, net of allowance	1,524	1,406
Bank-owned life insurance	12,420	12,458
Other assets	11,204	11,735
Total assets	\$ 594,204	\$ 606,286
Liabilities		
Deposits:		
Noninterest-bearing	\$ 100,024	\$ 87,971
Interest-bearing:		
Checking	208,036	222,371
Savings and money market accounts	135,737	126,714
Time deposits	67,284	88,159
Total interest-bearing	411,057	437,244
Total deposits	511,081	525,215
Federal Home Loan Bank advances	13,025	13,075
Company-obligated mandatorily redeemable capital securities	4,124	4,124
Other liabilities	8,891	8,715
Total liabilities	537,121	551,129
Shareholders' Equity		
Common stock, par value, \$3.13; authorized 8,000,000 shares; issued and outstanding: 2015: 3,744,562 shares including 33,267 non-vested shares; 2014: 3,730,877 shares including 34,965 non-vested shares	11,616	11,568
Retained earnings	45,613	43,690
Accumulated other comprehensive (loss), net	(146 )	(101 )
Total shareholders' equity	57,083	55,157
Total liabilities and shareholders' equity	\$ 594,204	\$ 606,286

See accompanying Notes to Consolidated Financial Statements.

2

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
(Unaudited)  
For the Three Months Ended September 30, 2015 and 2014

(In thousands, except per share data)

	2015	2014
Interest Income		
Interest and fees on loans	\$5,075	\$5,114
Interest and dividends on securities available for sale:		
Taxable interest income	275	275
Interest income exempt from federal income taxes	53	61
Dividends	31	31
Interest on deposits in other banks	26	45
Total interest income	5,460	5,526
Interest Expense		
Interest on deposits	309	502
Interest on federal funds purchased	7	-
Interest on Federal Home Loan Bank advances	82	83
Distribution on capital securities of subsidiary trusts	50	50
Total interest expense	448	635
Net interest income	5,012	4,891
Provision for loan losses	100	-
Net interest income after provision for loan losses	4,912	4,891
Other Income		
Trust and estate income	482	473
Brokerage income	42	83
Service charges on deposit accounts	598	662
Other service charges, commissions and income	759	712
Gain on sale of securities	3	-
Total other income	1,884	1,930
Other Expenses		
Salaries and benefits	2,750	2,677
Occupancy expense of premises	567	560
Furniture and equipment	280	264
Marketing expense	172	151
Legal, audit and consulting expense	290	235
Data processing expense	293	367
Federal Deposit Insurance Corporation expense	101	94
(Gain) on sale, impairment and expense of other real estate owned, net	(26 )	-
Other operating expenses	785	673
Total other expenses	5,212	5,021
Income before income taxes	1,584	1,800

Income tax expense	238	378
Net Income	\$1,346	\$1,422
Earnings per Share, basic	\$0.36	\$0.38
Earnings per Share, assuming dilution	\$0.36	\$0.38
Dividends per Share	\$0.12	\$0.12

See accompanying Notes to Consolidated Financial Statements.

3

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
(Unaudited)

For the Nine Months Ended September 30, 2015 and 2014  
(In thousands, except per share data)

	2015	2014
Interest Income		
Interest and fees on loans	\$ 15,071	\$ 15,254
Interest and dividends on securities available for sale:		
Taxable interest income	855	875
Interest income exempt from federal income taxes	166	184
Dividends	67	74
Interest on deposits in other banks	99	126
Total interest income	16,258	16,513
Interest Expense		
Interest on deposits	1,125	1,549
Interest on federal funds purchased	7	-
Interest on Federal Home Loan Bank advances	243	245
Distribution on capital securities of subsidiary trusts	149	149
Total interest expense	1,524	1,943
Net interest income	14,734	14,570
Provision for loan losses	200	-
Net interest income after provision for loan losses	14,534	14,570
Other Income		
Trust and estate income	1,435	1,349
Brokerage income	187	243
Service charges on deposit accounts	1,728	1,928
Other service charges, commissions and income	1,502	1,530
Gain on sale of securities	3	-
Total other income	4,855	5,050
Other Expenses		
Salaries and benefits	8,012	7,804
Occupancy expense of premises	1,744	1,665
Furniture and equipment	919	800
Marketing expense	456	434
Legal, audit and consulting expense	852	632
Data processing expense	944	1,072
Federal Deposit Insurance Corporation expense	294	279
(Gain) on sale or impairment and expense of other real estate owned, net	(12 )	(103 )
Other operating expenses	2,368	2,272
Total other expenses	15,577	14,855
Income before income taxes	3,812	4,765
Income tax expense	674	1,111

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Net Income	\$3,138	\$3,654
Earnings per Share, basic	\$0.84	\$0.98
Earnings per Share, assuming dilution	\$0.84	\$0.98
Dividends per Share	\$0.36	\$0.36

See accompanying Notes to Consolidated Financial Statements.

4

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Fauquier Bankshares, Inc. and Subsidiaries  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)  
 For the Three Months Ended September 30, 2015 and 2014

(In thousands)	2015	2014
Net Income	\$1,346	\$1,422
Other comprehensive income, net of tax:		
Interest rate swap, net of tax effect of \$24 in 2015 and \$(15) in 2014	(47 )	29
Change in fair value of securities available for sale, net of tax effect of \$(58) in 2015 and \$(7) in 2014	113	14
Total other comprehensive income, net of tax effect of \$(34) in 2015 and \$(22) in 2014	66	43
Comprehensive Income	\$1,412	\$1,465

For the Nine Months Ended September 30, 2015 and 2014

(In thousands)	2015	2014
Net Income	\$3,138	\$3,654
Other comprehensive income (loss), net of tax:		
Interest rate swap, net of tax effect of \$20 in 2015 and \$11 in 2014	(39 )	(22 )
Change in fair value of securities available for sale, net of tax effect of \$3 in 2015 and \$(426) in 2014	(6 )	827
Total other comprehensive income (loss), net of tax effect of \$23 in 2015 and \$(415) in 2014	(45 )	805
Comprehensive Income	\$3,093	\$4,459

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Changes in Shareholders' Equity  
(Unaudited)  
For the Nine Months Ended September 30, 2015 and 2014

(In thousands)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2013	\$ 11,516	\$ 40,652	\$ (941 )	\$ 51,227
Net income		3,654		3,654
Other comprehensive income net of tax effect of \$(415)			805	805
Cash dividends (\$.36 per share)		(1,343 )		(1,343 )
Amortization of unearned compensation, restricted stock awards		113		113
Issuance of common stock - non-vested shares (10,570 shares)	30	(30 )		-
Issuance of common stock - vested shares (6,965 shares)	22	82		104
Balance, September 30, 2014	\$ 11,568	\$ 43,128	\$ (136 )	\$ 54,560
Balance, December 31, 2014	\$ 11,568	\$ 43,690	\$ (101 )	\$ 55,157
Net income		3,138		3,138
Other comprehensive income net of tax effect of \$23			(45 )	(45 )
Cash dividends (\$.36 per share)		(1,349 )		(1,349 )
Amortization of unearned compensation, restricted stock awards		122		122
Issuance of common stock - non-vested shares (11,925 shares)	37	(37 )		-
Issuance of common stock - vested shares (3,458 shares)	11	49		60
Balance, September 30, 2015	\$ 11,616	\$ 45,613	\$ (146 )	\$ 57,083

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
(Unaudited)  
For the Nine Months Ended September 30, 2015 and 2014

(In thousands)	2015	2014
<b>Cash Flows from Operating Activities</b>		
Net income	\$3,138	\$3,654
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,068	911
Loss on disposal of furniture and equipment	23	-
Provision for loan losses	200	-
(Gain) on sale of other real estate owned	(34 )	(130 )
(Gain) loss on interest rate swaps	(20 )	44
(Gain) on sale and call of securities	(3 )	-
Amortization of security premiums, net	40	40
Amortization of unearned compensation, net of forfeiture	170	206
Issuance of vested restricted stock	60	104
Changes in assets and liabilities:		
(Increase) decrease in other assets	597	(764 )
Increase (decrease) in other liabilities	(39 )	1,333
Net cash provided by operating activities	5,200	5,398
<b>Cash Flows from Investing Activities</b>		
Proceeds from maturities, calls and principal payments of securities available for sale	9,256	8,027
Purchase of securities available for sale	(7,399 )	(8,445 )
Purchase of premises and equipment	(649 )	(6,662 )
Redemptions restricted securities	8	168
Net (increase) decrease in loans	(26,274)	13,511
Proceeds from sale of other real estate owned	499	2,809
Net cash provided by (used in) investing activities	(24,559)	9,408
<b>Cash Flows from Financing Activities</b>		
Net increase (decrease) in demand deposits, NOW accounts and savings accounts	6,741	(16,177)
Net (decrease) in certificates of deposit	(20,875)	(16,208)
(Decrease) in FHLB advances	(50 )	(47 )
Cash dividends paid on common stock	(1,349 )	(1,343 )
Net cash (used in) financing activities	(15,533)	(33,775)
(Decrease) in cash and cash equivalents	(34,892)	(18,969)
<b>Cash and Cash Equivalents</b>		
Beginning	64,376	71,126
Ending	\$29,484	\$52,157
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$1,600	\$1,954
Income taxes	\$260	\$966

Supplemental Disclosures of Noncash Investing Activities

Unrealized gain (loss) on securities available for sale, net of tax effect	\$ (6	) \$ 827
Unrealized (loss) on interest rate swap, net of taxes	\$ (39	) \$ (22 )
Loans transferred to other real estate owned	\$ 583	\$ -

See accompanying Notes to Consolidated Financial Statements.

7

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FAUQUIER BANKSHARES, INC. AND SUBSIDIARIES

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 subsidiary, The Fauquier Bank ("the Bank"), and the Bank's wholly-owned subsidiary, Fauquier Bank Services, Inc. The consolidated financial statements do not include the accounts of Fauquier Statutory Trust II, a wholly-owned subsidiary of the Company. 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, 2015 and December 31, 2014 and the results of operations for the three and nine months ended September 30, 2015 and 2014. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's 2014 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the "SEC").

The results of operations for the three and nine months ended September 30, 2015 are not necessarily indicative of the results expected for the full year or any other interim period.

Recent Accounting Pronouncements

In June 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-12, "Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in "Compensation – Stock Compensation (Topic 718)," should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company is currently assessing the impact that ASU 2014-12 will have on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have a material impact on its consolidated financial statements.



In November 2014, the FASB issued ASU No. 2014-16, "Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity." The amendments in ASU do not change the current criteria in accounting principles generally accepted in the United States ("GAAP") for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. The amendments clarify how current GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features, including the embedded derivative feature being evaluated for bifurcation, in evaluating the nature of the host contract. Furthermore, the amendments clarify that no single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument. The amendments in this ASU also clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (i.e., the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption, including adoption in an interim period, is permitted. The Company does not expect the adoption of ASU 2014-16 to have a material impact on its consolidated financial statements.

In January 2015, the FASB issued ASU No. 2015-01, "Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items." The amendments in this ASU eliminate from GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. If an event or transaction meets the criteria for extraordinary classification, an entity is required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also is required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company does not expect the adoption of ASU 2015-01 to have a material impact on its consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis." The amendments in this ASU are intended to improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). In addition to reducing the number of consolidation models from four to two, the new standard simplifies the FASB Accounting Standards Codification and improves current GAAP by placing more emphasis on risk of loss when determining a controlling financial interest, reducing the frequency of the application of related-party guidance when determining a controlling financial interest in a variable interest entity ("VIE"), and changing consolidation conclusions for public and private companies in several industries that typically make use of limited partnerships or VIEs. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. ASU 2015-02 may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. The Company does not expect the adoption of ASU 2015-02 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, "Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." The amendments in this ASU are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with

debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. The amendments in this ASU are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The Company does not expect the adoption of ASU 2015-03 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement." The amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments do not change the accounting for a customer's accounting for service contracts. As a result of the amendments, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets. The amendments in this ASU are effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. An entity can elect to adopt the amendments either: (1) prospectively to all arrangements entered into or materially modified after the effective date; or (2) retrospectively. The Company is currently assessing the impact that ASU 2015-05 will have on its consolidated financial statements.

In May 2015, the FASB issued ASU No. 2015-08, "Business Combinations (Topic 805): Pushdown Accounting – Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115." The amendments in this ASU amend various SEC paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 115, Topic 5: Miscellaneous Accounting, regarding various pushdown accounting issues, and did not have a material impact on the Company's consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-12, "Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), and Health and Welfare Benefit Plans (Topic 965) – 1. Fully Benefit-Responsive Investment Contracts, 2. Plan Investment Disclosures, and 3. Measurement Date Practical Expedient." The amendments within this ASU are in three parts. Among other things, Part 1 amendments designate contract value as the only required measure for fully benefit-responsive investment contracts; Part 2 amendments eliminate the requirement that plans disclose: (a) individual investments that represent 5 percent or more of net assets available for benefits; and (b) the net appreciation or depreciation for investments by general type requirements for both participant-directed investments and nonparticipant-directed investments. Part 3 amendments provide a practical expedient to permit plans to measure investments and investment-related accounts (e.g., a liability for a pending trade with a broker) as of a month-end date that is closest to the plan's fiscal year-end, when the fiscal period does not coincide with month-end. The amendments in Parts 1 and 2 of this ASU are effective on a retrospective basis and Part 3 is effective on a prospective basis, for fiscal years beginning after December 15, 2015. Early adoption is permitted. The Company is currently assessing the impact that ASU 2015-12 will have on its consolidated financial statements.

In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of Effective Date." The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. All other entities may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities also may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which the entity first applies the guidance in ASU 2014-09. The Company does not expect the adoption of ASU 2015-14 (or ASU 2014-09) to have a material impact on its consolidated financial statements.

In August 2015, the FASB issued ASU 2015-15, "Interest – Imputation of Interest (Subtopic 835-30) – Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting)." On April 7, 2015, the FASB issued ASU 2015-03, Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The guidance in ASU 2015-03 (see paragraph 835-30-45-1A) does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff stated that they would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. ASU 2015-15 adds these SEC comments to the "S" section of the Codification. The Company does not expect the adoption of ASU 2015-15 to have a material impact on its consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, "Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments." The amendments in ASU 2015-16 require that an acquirer

recognize adjustments to estimated amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the estimated amounts, calculated as if the accounting had been completed at the acquisition date. The amendments also require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the estimated amounts had been recognized as of the acquisition date. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date with earlier application permitted for financial statements that have not been issued. The Company does not expect the adoption of ASU 2015-16 to have a material impact on its 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, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Obligations of U.S. Government corporations and agencies	\$45,323	\$ 603	\$ (68 )	\$45,858
Obligations of states and political subdivisions	5,925	301	-	6,226
Corporate bonds	3,653	-	(607 )	3,046
Mutual funds	368	6	-	374
	\$55,269	\$ 910	\$ (675 )	\$55,504

  

(In thousands)	December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Obligations of U.S. Government corporations and agencies	\$46,666	\$ 464	\$ (165 )	\$46,965
Obligations of states and political subdivisions	6,537	377	-	6,914
Corporate bonds	3,597	34	(470 )	3,161
Mutual funds	362	4	-	366
	\$57,162	\$ 879	\$ (635 )	\$57,406

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, 2015	
	Amortized Cost	Fair Value
Due in one year or less	\$2,000	\$2,001
Due after one year through five years	13,842	14,009
Due after five years through ten years	6,909	7,150
Due after ten years	32,150	31,970
Equity securities	368	374
	\$55,269	\$55,504

There were no impairment losses on securities during the three and nine months ended September 30, 2015 and 2014.

During the nine months ended September 30, 2015, no securities were sold, and five securities totaling \$3.8 million were called. Over the same period, six securities totaling \$7.4 million were purchased. During the nine months ended September 30, 2014, no securities were sold, and three securities, totaling a fair value of \$4.6 million, were called or matured. Over the same period, seven securities totaling \$8.4 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 September 30, 2015 and December 31, 2014, respectively.

(In thousands)	12 Months or More	Total
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	Less than 12 Months					
September 30, 2015	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
Obligations of U.S. Government, corporations and agencies	\$4,092	\$ (10 )	\$3,862	\$ (58 )	\$7,954	\$ (68 )
Corporate bonds	596	(17 )	2,450	(590 )	3,046	(607 )
Total temporary impaired securities	\$4,688	\$ (27 )	\$6,312	\$ (648 )	\$11,000	\$ (675 )
(In thousands)	Less than 12 Months		12 Months or More		Total	
December 31, 2014	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
Obligations of U.S. Government, corporations and agencies	\$10,405	\$ (35 )	\$8,412	\$ (130 )	\$18,817	\$ (165 )
Corporate bonds	-	-	2,531	(470 )	2,531	(470 )
Total temporary impaired securities	\$10,405	\$ (35 )	\$10,943	\$ (600 )	\$21,348	\$ (635 )

The nature of securities which were temporarily impaired for a continuous twelve month period or more at September 30, 2015 consisted of three corporate bonds with a cost basis net of other-than-temporary impairment ("OTTI") totaling \$3.7 million and a temporary loss of approximately \$607,000. The value of these corporate bonds is based on quoted market prices for similar assets. They 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 58 different financial institutions per bond. They have an estimated maturity of 19 years. These bonds could have been called at par on the five year anniversary date of issuance, which has already passed for all the 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, 2015. The bonds, totaling \$3.0 million at fair value, are projected to repay the full outstanding interest and principal and are now classified as performing corporate bond investments. During the nine months ended September 30, 2015, \$159,000 of interest income was received and recorded, of which \$87,000 represented deferred interest from prior periods.

Additional information regarding each of the pooled trust preferred securities as of September 30, 2015 follows:  
(Dollars in thousands)

Cost, net of OTTI loss	Fair Value(1)	Percent of Underlying Collateral Performing	Percent of Underlying Collateral in Deferral	Percent of Underlying Collateral in Default	Cumulative Amount of OTTI Loss	Cumulative Other Comprehensive Loss (Income), net of tax benefit
\$1,648	\$ 1,220	78.5	% 4.4	% 17.1	% \$ 309	\$ 283
1,392	1,230	80.3	% 9.1	% 10.6	% 609	107
613	596	82.2	% 8.1	% 9.7	% 387	11
\$3,653	\$ 3,046				\$ 1,305	\$ 401

(1)Current Moody's Ratings range from B2 to Caa3.

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, 2014	\$1,360
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	-
	(55 )

Less: Increases in cash flows expected to be collected that are recognized over the remaining life of the security (See FASB ASC 320-10-35-35)

Ending balance as of September 30, 2015 \$1,305

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$46.3 million and \$47.6 million at September 30, 2015 and December 31, 2014, respectively.



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, 2015

(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 12/31/2014	\$516	\$ 1,943	\$ 699	\$ 37	\$72	\$ 1,424	\$296	\$ 404	\$5,391
Charge-offs	(6 )	(568 )	(17 )	(7 )	(40 )	(167 )	(50 )	-	(855 )
Recoveries	1	-	-	11	-	25	3	-	40
Provision	(155 )	158	156	(25 )	94	(264 )	79	157	200
Ending balance at 9/30/2015	\$356	\$ 1,533	\$ 838	\$ 16	\$126	\$ 1,018	\$328	\$ 561	\$4,776
Ending balances individually evaluated for impairment	\$121	\$ 38	\$ 300	\$ -	\$ -	\$ -	\$ -	\$ -	\$459
Ending balances collectively evaluated for impairment	\$235	\$ 1,495	\$ 538	\$ 16	\$126	\$ 1,018	\$328	\$ 561	\$4,317
Loans Receivable Individually evaluated for impairment	\$235	\$ 3,002	\$ 3,566	\$ -	\$ -	\$422	\$70		\$7,295
Collectively evaluated for impairment	31,218	167,096	44,613	3,266	16,263	151,971	43,759		458,186
Ending balance at 9/30/2015	\$31,453	\$ 170,098	\$ 48,179	\$ 3,266	\$16,263	\$ 152,393	\$43,829		\$465,481

13

As of and for the Year Ended December 31, 2014

(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 12/31/2013	\$964	\$2,320	\$412	\$18	\$196	\$1,261	\$1,314	\$182	\$6,667
Charge-offs	(171 )	(560 )	(313 )	(18 )	(139 )	(172 )	(91 )	-	(1,464 )
Recoveries	86	-	65	10	-	22	5	-	188
Provision	(363 )	183	535	27	15	313	(932 )	222	-
Ending balance at 12/31/2014	\$516	\$1,943	\$699	\$37	\$72	\$1,424	\$296	\$404	\$5,391
Ending balances individually evaluated for impairment	\$246	\$456	\$470	\$-	\$-	\$173	\$-	\$-	\$1,345
Ending balances collectively evaluated for impairment	\$270	\$1,487	\$229	\$37	\$72	\$1,251	\$296	\$404	\$4,046
Loans Receivable Individually evaluated for impairment	\$316	\$3,272	\$3,620	\$-	\$-	\$1,550	\$70		\$8,828
Collectively evaluated for impairment	26,608	162,256	35,465	3,015	19,700	141,927	42,662		431,633
Ending balance at 12/31/2014	\$26,924	\$165,528	\$39,085	\$3,015	\$19,700	\$143,477	\$42,732		\$440,461

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, 2015

(In thousands)	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Total
Grade:								
Pass	\$28,331	\$ 158,317	\$ 39,302	\$ 3,263	\$16,263	\$ 143,689	\$40,151	\$429,316
Special mention	1,156	7,046	5,726	3	-	1,828	855	16,614
Substandard	1,966	4,735	3,151	-	-	6,817	2,823	19,492
Doubtful	-	-	-	-	-	59	-	59
Loss	-	-	-	-	-	-	-	-
Total	\$31,453	\$ 170,098	\$ 48,179	\$ 3,266	\$16,263	\$ 152,393	\$43,829	\$465,481

December 31, 2014

(In thousands)	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Total
Grade:								
Pass	\$23,685	\$ 154,228	\$ 32,028	\$ 2,994	\$19,700	\$ 132,168	\$37,878	\$402,681
Special mention	1,606	3,898	2,785	21	-	2,299	2,217	12,826
Substandard	1,633	7,402	4,272	-	-	9,010	2,578	24,895
Doubtful	-	-	-	-	-	-	59	59
Loss	-	-	-	-	-	-	-	-
Total	\$26,924	\$ 165,528	\$ 39,085	\$ 3,015	\$19,700	\$ 143,477	\$42,732	\$440,461

## Age Analysis of Past Due Loans Receivable

	As of September 30, 2015				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				
(In thousands)								
Commercial and industrial	\$102	\$15	\$8	\$125	\$31,328	\$31,453	\$-	\$174
Commercial real estate	-	-	88	88	170,010	170,098	-	416
Construction and land	-	-	1,485	1,485	46,694	48,179	-	1,485
Consumer	2	3	-	5	3,261	3,266	-	-
Student (U.S. Government guaranteed)	923	676	2,907	4,506	11,757	16,263	2,907	-
Residential real estate	381	-	230	611	151,782	152,393	-	230
Home equity line of credit	70	-	-	70	43,759	43,829	-	-
Total	\$1,478	\$694	\$4,718	\$6,890	\$458,591	\$465,481	\$2,907	\$2,305

	As of December 31, 2014				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				
(In thousands)								
Commercial and industrial	\$140	\$106	\$-	\$246	\$26,678	\$26,924	\$-	\$166
Commercial real estate	444	-	-	444	165,084	165,528	-	98
Construction and land	551	145	-	696	38,389	39,085	-	1
Consumer	8	18	-	26	2,989	3,015	-	-
Student (U.S. Government guaranteed)	1,445	830	4,551	6,826	12,874	19,700	4,551	-
Residential real estate	798	1,242	459	2,499	140,978	143,477	-	962
Home equity line of credit	50	108	-	158	42,574	42,732	-	-
Total	\$3,436	\$2,449	\$5,010	\$10,895	\$429,566	\$440,461	\$4,551	\$1,227

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, 2015, \$2.9 million of the student loans were 90 days or more past due and still accruing.

## Impaired Loans Receivable

(In thousands)	September 30, 2015				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance recorded:					
Commercial and industrial	\$64	\$ 90	\$ -	\$ 80	\$ 4
Commercial real estate	2,914	3,491	-	3,214	82
Construction and land	2,081	2,081	-	2,094	41
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	422	422	-	428	14
Home equity line of credit	70	70	-	70	2
Consumer	-	-	-	-	-
With an allowance recorded:					
Commercial and industrial	\$171	\$ 185	\$ 121	\$ 183	\$ 1
Commercial real estate	88	90	38	90	3
Construction and land	1,485	1,485	300	1,489	33
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	-	-	-	-	-
Home equity line of credit	-	-	-	-	-
Consumer	-	-	-	-	-
Total:					
Commercial and industrial	\$235	\$ 275	\$ 121	\$ 263	\$ 5
Commercial real estate	3,002	3,581	38	3,304	85
Construction and land	3,566	3,566	300	3,583	74
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	422	422	-	428	14
Home equity line of credit	70	70	-	70	2
Consumer	-	-	-	-	-
Total	\$7,295	\$ 7,914	\$ 459	\$ 7,648	\$ 180

(In thousands)	December 31, 2014				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance recorded:					
Commercial and industrial	\$20	\$ 50	\$ -	\$ 33	\$ -
Commercial real estate	1,438	2,006	-	1,722	108
Construction and land	1,577	1,893	-	1,737	79
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	1,220	1,477	-	1,351	19
Home equity line of credit	70	70	-	70	3
Consumer	-	-	-	-	-
With an allowance recorded:					
Commercial and industrial	\$296	\$ 304	\$ 246	\$ 312	\$ 11

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Commercial real estate	1,834	1,834	456	1,835	102
Construction and land	2,043	2,043	470	2,064	110
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	330	338	173	445	21
Home equity line of credit	-	-	-	-	-
Consumer	-	-	-	-	-

Total:

Commercial and industrial	\$316	\$354	\$246	\$345	\$11
Commercial real estate	3,272	3,840	456	3,557	210
Construction and land	3,620	3,936	470	3,801	189
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	1,550	1,815	173	1,796	40
Home equity line of credit	70	70	-	70	3
Consumer	-	-	-	-	-
Total	\$8,828	\$10,015	\$1,345	\$9,569	\$453

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, 2015, there were \$3.5 million of commercial loans classified as substandard which were deemed not to be impaired because borrowers continue to abide by the terms of their original loan agreements and are substandard based on their industry or changes in their cash flow that have not yet resulted in past dues. Impaired loans totaled \$7.3 million at September 30, 2015, representing a decrease of \$1.5 million from December 31, 2014. Approximately \$7.1 million of loans classified as impaired at September 30, 2015 were collateralized by commercial buildings, residential real estate, or land.

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

The following tables represent loans modified in a troubled debt restructuring ("TDRs") during the nine months ended September 30, 2015 and 2014.

#### Troubled Debt Restructurings

	Nine Months Ended September 30, 2015		Nine Months Ended September 30, 2014	
	Pre-Modification Number of Outstanding Recorded Contracts	Post-Modification Outstanding Recorded Investment	Pre-Modification Number of Outstanding Recorded Contracts	Post-Modification Outstanding Recorded Investment
(Dollars in thousands)				
Troubled Debt Restructurings				
Commercial and industrial	1	\$ 340	2	\$ 198
Commercial real estate	1	1,342	1	1,900
Construction and land	-	-	-	-
Consumer	-	-	-	-
Student	-	-	-	-
Residential real estate	-	-	-	-
Home equity line of credit	-	-	-	-

There were no loans modified in TDRs and no TDRs defaulted within 12 months of modification during the three months ended September 30, 2015 and 2014. At September 30, 2015, 12 TDRs, totaling \$7.1 million, remain in the portfolio. Seven of the loans, totaling \$5.2 million, were on accrual status and performing in accordance with the modified terms. The remaining five loans, totaling \$1.9 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.

At September 30, 2015, the Company had one foreclosed residential real estate property in its possession. There were two residential real estate properties with a total carrying value of \$242,000 that were in the process of foreclosure.



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

(Dollars in thousands)	September 30, 2015	December 31, 2014	September 30, 2014			
Non-accrual loans	\$ 2,305	\$ 1,227	\$ 2,233			
Other real estate owned	1,524	1,406	1,406			
Total non-performing assets	3,829	2,633	3,639			
Restructured loans still accruing	5,220	7,431	8,323			
Student loans (U.S. Government guaranteed) past due 90 days or more and still accruing	2,907	4,551	4,059			
Total non-performing and other risk assets	\$ 11,956	\$ 14,615	\$ 16,021			
Allowance for loan losses to total loans	1.03	%	1.22	%	1.51	%
Non-accrual loans to total loans	0.50	%	0.28	%	0.51	%
Allowance for loan losses to non-accrual loans	207.20	%	439.36	%	295.34	%
Total non-accrual loans and restructured loans still accruing to total loans	1.62	%	1.97	%	2.41	%
Allowance for loan losses to non-accrual loans and restructured loans still accruing	63.47	%	62.27	%	62.48	%
Total non-performing assets to total assets	0.64	%	0.43	%	0.62	%

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 1.70% above the then current three month LIBOR. Interest is paid quarterly. Total capital securities at September 30, 2015 and December 31, 2014 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

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 risk 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 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 1.70%, 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 4.91%. The interest expense on the interest rate swap was \$30,000 for each of the three months ended September 30, 2015 and 2014. The interest expense on the interest rate swap was \$89,000 and \$90,000 for the nine months ended September 30, 2015 and 2014, 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 four swap agreements to manage the interest rate risk related to four commercial loans.

The agreements allow the Company to convert fixed rate assets to floating rate assets through 2021 and 2025. 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 \$48,000 and \$27,000 for the three months ended September 30, 2015 and 2014, respectively, and is recorded in loan interest income. For the nine months ended September 30, 2015 and 2014, the interest expense was \$129,000 and \$81,000, respectively. These swaps are designated as fair value hedges and changes in fair value are recorded in current

earnings.

Cash collateral held at other banks for these swaps was \$850,000 at September 30, 2015. Collateral posted and received is dependent on the market valuation of the underlying hedges.

20

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The effects of derivative instruments on the Consolidated Financial Statements for September 30, 2015 and December 31, 2014 are as follows:

(In thousands)	September 30, 2015				
	Estimated				
	Notional	Net	Fair Value	Expiration	
	Contract	Fair	Balance Sheet	Dates	
Derivatives designated as hedging instruments	Amount	Value	Location	From	Expiration Dates To
Interest rate swap-cash flow	\$4,000	\$ (362	)Other Liabilities	-	9/15/2020
Interest rate swaps-fair value	9,089	(236	)Other Liabilities	8/15/2021	4/9/2025

	September 30, 2015		
	Amount		
	of		
	Gain		
	(Loss)		
	Recognized		
	in	Location of	
	OCI	Gain or	Amount of
	on	(Loss)	Gain (Loss)
	Derivatives	Recognized	Recognized
	net	in	in Income
	of	Income on	on
	tax	Derivative	Derivative
Derivatives in cash flow hedging relationships	(Effective	(Ineffective	(Ineffective
	Portion)	Portion)	Portion)
	Not		
Interest rate swaps	\$(39) applicable	\$	-

(In thousands)	September 30, 2015	
	Gain	
	or	
	(Loss)	
	Income Statement on	
Derivatives in fair value hedging relationships	Classification	Swaps
Interest rate swaps	Interest income	\$ 20

(In thousands)	December 31, 2014				
	Estimated				
	Notional	Net	Fair Value	Expiration	
	Contract	Fair	Balance Sheet	Dates	
Derivatives designated as hedging instruments	Amount	Value	Location	Date From	Expiration Dates To
Interest rate swap-cash flow	\$4,000	\$ (304	)Other Liabilities	-	9/15/2020
Interest rate swaps-fair value	4,107	(129	)Other Liabilities	-	8/15/2021
Interest rate swap-fair value	1,000	16	Other Assets	2/12/2022	4/9/2025

December 31, 2014

	Amount of Gain (Loss) Recognized in Location of OCI Gain or on (Loss) Amount of Derivatives Recognized net in Recognized of Income on in Income tax Derivative Derivative Derivatives in cash flow hedging relationships (Effective (Ineffective Portion) Portion)	
Interest rate swaps	Not applicable	\$ (53) \$ -
(In thousands)	December 31, 2014	
		Gain or (Loss)
Derivatives in fair value hedging relationships	Income Statement Classification	on Swaps
Interest rate swaps	Interest Income	\$ (58 )

## 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 for the periods indicated.

	Three Months Ended September 30, 2015		Three Months Ended September 30, 2014	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,744,562	\$ 0.36	3,730,877	\$ 0.38
Effect of dilutive securities, stock-based awards	19,854		20,439	
Diluted earnings per share	3,764,416	\$ 0.36	3,751,316	\$ 0.38

  

	Nine Months Ended September 30, 2015		Nine Months Ended September 30, 2014	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,742,106	\$ 0.84	3,727,453	\$ 0.98
Effect of dilutive securities, stock-based awards	16,983		17,422	
Diluted earnings per share	3,759,089	\$ 0.84	3,744,875	\$ 0.98

Non-vested restricted shares have voting rights and receive non-forfeitable dividends during the vesting period; therefore, they are included in calculating basic earnings per share. The portion of non-vested performance-based stock awards that have been earned but not yet awarded are included in the diluted earnings per share.

## 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. The Company did not grant stock options during the three and nine months ended September 30, 2015 and there were no options outstanding at September 30, 2015.

## 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 recognized over the three year period. The restricted shares 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 Plan: 10,227 shares and 10,570 shares of non-vested restricted stock to executive officers, and 3,458 shares and 4,050 shares of vested restricted stock to non-employee directors on February 19, 2015 and February 20, 2014, respectively. The compensation expense for these non-vested shares is recognized over a period of three years, and was \$41,000 and \$38,000, net of forfeiture, for the three months ended September 30, 2015 and 2014 and \$122,000 and \$113,000 for the nine months ended September 30, 2015 and 2014, respectively. As of September 30, 2015, there was \$228,000 of total unrecognized compensation cost related to these non-vested shares, which will be recorded in conjunction with the vesting periods over the remaining 27 months. 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, 2015 and 2014, no expense was recognized. For the nine months ended September 30, 2015 and 2014, \$59,000 and \$64,000 of compensation expense for non-employee director shares was recognized, respectively.

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

	Nine Months Ended September 30, 2015	
	Shares	Weighted Average Fair Value
Non-vested at January 1, 2015	34,965	\$ 13.11
Granted	13,685	17.20
Vested	(15,383)	13.23
Forfeited	-	
Non-vested at September 30, 2015	33,267	\$ 14.74

The Company granted performance-based stock rights relating to 10,227 and 10,746 shares to certain officers on February 19, 2015, and February 20, 2014, 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 \$2,000 and \$36,000 for the three months ended September 30, 2015 and 2014, respectively. For the nine months ended September 30, 2015 and 2014, compensation expense for performance-based stock rights was \$49,000 and \$92,000, respectively.

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

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	Nine Months Ended September 30, 2015 Performance	
	Based Stock Rights (Shares)	Weighted Average Fair Value
Non-vested at January 1, 2015	35,141	\$ 13.12
Granted	10,227	17.20
Vested	-	
Forfeited	(11,925)	12.08
Non-vested at September 30, 2015	33,443	\$ 14.74

23

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## Note 8.

## Employee Benefit Plans

The Company has a defined contribution retirement plan under Internal Revenue Code of 1986 ("Code") Section 401(k) covering all employees 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 50% 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 both the three months ended September 30, 2015 and 2014 were \$183,000. For the nine months ended September 30, 2015 and 2014, 401(k) expenses were \$529,000 and \$527,000, 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. For the three months ended September 30, 2015 and 2014, deferred compensation expense was \$12,000 and \$8,000, respectively. For the nine months ended September 30, 2015 and 2014, compensation expense was \$34,000 and \$28,000, 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 plan. Income on these life insurance policies amounted to \$8,000 for each of the three months, and \$24,000 for each of the nine months, ended September 30, 2015 and 2014, respectively. The Company has recorded other assets of \$1.3 million representing the cash surrender value of these policies at both September 30, 2015 and December 31, 2014.

## 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.

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

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

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

**Securities available for sale:** Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data (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. The vendor's primary source for security valuation is Interactive Data Corporation ("IDC"), which evaluates 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 modes, vast descriptive terms and conditions databases, as well as extensive quality control programs.

**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.

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2015 and December 31, 2014 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)
Assets at September 30, 2015:				
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	\$45,858	\$ -	\$ 45,858	\$ -
Obligations of states and political subdivisions	6,226	-	6,226	-
Corporate bonds	3,046	-	3,046	-
Mutual funds	374	374	-	-
Total available for sale securities	55,504	374	55,130	-
Total assets at fair value	\$55,504	\$ 374	\$ 55,130	\$ -
Liabilities at September 30, 2015:				
Interest rate swaps	\$598	\$ -	\$ 598	\$ -
Total liabilities at fair value	\$598	\$ -	\$ 598	\$ -

Assets at December 31, 2014:

Available for sale securities:

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Obligations of U.S. Government corporations and agencies	\$46,965	\$ -	\$ 46,965	\$ -
Obligations of states and political subdivisions	6,914	-	6,914	-
Corporate bonds	3,161	-	3,161	-
Mutual funds	366	366	-	-
Total available for sale securities	57,406	366	57,040	-
Interest rate swaps	16	-	16	-
Total assets at fair value	\$57,422	\$ 366	\$ 57,056	\$ -
Liabilities at December 31, 2014:				
Interest rate swaps	\$433	\$ -	\$ 433	\$ -
Total liabilities at fair value	\$433	\$ -	\$ 433	\$ -

There were no Level 3 assets measured at estimated fair value on a recurring basis as of September 30, 2015 or December 31, 2014.

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

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

**Impaired Loans:** A loan is 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 an impaired loan can be based on either the observable market price of the loan or the fair value of the collateral securing the loan. 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, 2015, the Company's Level 3 loans for which a reserve has been established, consisted of two loans totaling \$121,000 secured by business assets and inventory with a reserve of \$115,000, and one loan totaling \$318,000 secured by real estate with a reserve of \$279,000.

**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 the OREO as nonrecurring Level 3. Total valuation of OREO property was \$1.5 million at September 30, 2015 and \$1.4 million at December 31, 2014.

The following table summarizes the Company's financial assets that were measured at fair value at September 30, 2015 and December 31, 2014.

	Carrying Value at September 30, 2015			
	Balance for as of September 30, 2015	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
(In thousands)				
Assets:				
Impaired loans, net	\$1,285	\$ -	\$ 1,240	\$ 45

Other real estate owned, net    1,524            -            1,524            -

Carrying Value at December 31, 2014

		Quoted Prices in Active Markets		Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	Balance for as of December 31, 2014	Assets (Level 1)			
(In thousands)					
Assets:					
Impaired loans, net	\$3,158	\$ -		\$ 3,109	\$ 49
Other real estate owned, net	1,406	-		1,406	-

The following table displays quantitative information about Level 3 Fair Value Measurements at September 30, 2015 and December 31, 2014.

Quantitative Information about Level 3 Fair Value Measurements at September 30, 2015

(In thousands)	Fair Valuation Technique(s)	Unobservable Input	Weighted Average Discount
Impaired loans	\$45 Appraised values	Age of appraisal, current market conditions, and experience within local markets	90 %
Total	\$45		

Quantitative Information about Level 3 Fair Value Measurements at December 31, 2014

(In thousands)	Fair Valuation Technique(s)	Unobservable Input	Weighted Average Discount
Impaired loans	\$49 Appraised values	Age of appraisal, current market conditions, and experience within local markets	92 %
Total	\$49		

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. Restricted securities are carried at cost based on redemption provisions of the issuers. 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.

**Borrowed Funds:** The fair values of the Company's advances from the Federal Home Loan Bank of Atlanta 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, 2015 and December 31, 2014, the fair values of loan commitments and standby letters of credit were deemed immaterial.

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

(In thousands)	Fair Value Measurements at September 30, 2015				
	Carrying Value of September 30, 2015	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, 2015
<b>Assets</b>					
Cash and short-term investments	\$29,484	\$30,002	\$-	\$-	\$30,002
Securities available for sale	55,504	374	55,130	-	55,504
Restricted investments	1,286	-	1,286	-	1,286
Net loans	460,705	-	468,141	45	468,186
Accrued interest receivable	1,450	-	1,450	-	1,450
BOLI	12,420	-	12,420	-	12,420
<b>Total financial assets</b>	<b>\$560,849</b>	<b>\$30,376</b>	<b>\$538,427</b>	<b>\$45</b>	<b>\$568,848</b>
<b>Liabilities</b>					
Deposits	\$511,081	\$-	\$483,486	\$-	\$483,486
Borrowings	13,025	-	13,239	-	13,239
Company obligated mandatorily redeemable capital securities	4,124	-	4,246	-	4,246
Accrued interest payable	110	-	110	-	110
Interest rate swaps	598	-	598	-	598
<b>Total financial liabilities</b>	<b>\$528,938</b>	<b>\$-</b>	<b>\$501,679</b>	<b>\$-</b>	<b>\$501,679</b>

(In thousands)	Fair Value Measurements at December 31, 2014				
	Carrying Value of December 31, 2014	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, 2014
<b>Assets</b>					
Cash and short-term investments	\$64,376	\$64,441	\$-	\$-	\$64,441
Securities available for sale	57,406	366	57,040	-	57,406
Restricted investments	1,294	-	1,294	-	1,294
Net loans	435,070	-	434,356	49	434,405
Accrued interest receivable	1,473	-	1,473	-	1,473
Interest rate swaps	16	-	16	-	16
BOLI	12,458	-	12,458	-	12,458
<b>Total financial assets</b>	<b>\$572,093</b>	<b>\$64,807</b>	<b>\$506,637</b>	<b>\$49</b>	<b>\$571,493</b>

Liabilities					
Deposits	\$525,215	\$-	\$525,636	\$-	\$525,636
Borrowings	13,075	-	13,182	-	13,182
Company obligated mandatorily redeemable capital securities	4,124	-	4,117	-	4,117
Accrued interest payable	185	-	185	-	185
Interest rate swaps	433	-	433	-	433
Total financial liabilities	\$543,032	\$-	\$543,553	\$-	\$543,553

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

## Note 10. 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, 2014	\$ (200 )	\$ 160	\$ (61 )	\$ (101)
Other comprehensive income (loss) before reclassifications	(39 )	(6 )	-	(45 )
Amounts reclassified from accumulated other comprehensive income	-	-	-	-
Net current-period other comprehensive income (loss)	(39 )	(6 )	-	(45 )
Balance September 30, 2015	\$ (239 )	\$ 154	\$ (61 )	\$ (146)
Balance December 31, 2013	\$ (147 )	\$ (847 )	\$ 53	\$ (941)
Other comprehensive income (loss) before reclassifications	(22 )	827	-	805
Amounts reclassified from accumulated other comprehensive income	-	-	-	-
Net current-period other comprehensive income (loss)	(22 )	827	-	805
Balance September 30, 2014	\$ (169 )	\$ (20 )	\$ 53	\$ (136)

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

## Note 11. Investment in Affordable Housing Projects

The Company has investments in certain affordable housing projects located in the Commonwealth of Virginia through six limited liability partnerships of the Bank. These partnerships exist to develop and preserve affordable housing for low income families through residential rental property projects. The Company exerts no control over the operating or financial policies of the partnerships. Return on these investments is through receipt of tax credits and other tax benefits which are subject to recapture by taxing authorities based on compliance features at the project level. The investments are due to expire by 2032. The Company accounts for the affordable housing investments using the equity method and has recorded \$4.3 million in other assets at September 30, 2015. The Company has also recorded \$3.5 million in other liabilities related to capital calls through 2019. The related federal tax credits and other tax benefits for the three and nine months ended September 30, 2015 were \$145,000 and \$331,000, and \$63,000 and \$188,000 for the same periods ended September 30, 2014, respectively, and were included in income tax expense in the Consolidated Statements of Income. There were \$155,000 in flow-through losses recognized during the quarter ended September 30, 2015. None were recognized in the the quarter ended September 30, 2014.

## 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 3,744,562 shares of common stock, par value \$3.13 per share, held by approximately 342 holders of record at the close of business on September 30, 2015. The Bank has 11 full service branch offices located in the Virginia communities of Old Town-Warrenton, Warrenton, Catlett, The Plains, Sudley Road-Manassas, New Baltimore, Bealeton, Bristow, Haymarket, Gainesville, and Centreville Road-Manassas. 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 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 certificates of deposit 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 of Atlanta ("FHLB"). 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, 2015, the Company had total consolidated assets of \$594.2 million, total loans net of allowance for loan losses of \$460.7 million, total consolidated deposits of \$511.1 million, and total consolidated shareholders' equity of \$57.1 million.

## CRITICAL ACCOUNTING POLICIES

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

**ALLOWANCE FOR LOAN LOSSES.** The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on three basic principles of accounting: (i) Accounting Standards Codification ("ASC") 450 "Contingencies" which requires that losses be accrued when they are probable of occurring and estimable, (ii) ASC 310 "Receivables" 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. All troubled debt restructurings ("TDRs"), regardless of loan type or amount, are evaluated individually for impairment. 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 \$1.35 million for the third quarter of 2015 was a 5.3% decrease from the net income of \$1.42 million for the third quarter of 2014. Loans, net of reserve, totaling \$460.7 million at September 30, 2015, increased 5.9% when compared with December 31, 2014, and increased 6.8% when compared with September 30, 2014. Deposits, totaling \$511.1 million at September 30, 2015, decreased 2.7% when compared with December 31, 2014, but increased 0.6% when compared with September 30, 2014. Assets under WMS management, totaling \$426.0 million in market value at September 30, 2015, and decreased 2.0 % from December 31, 2014 and 0.4 % from September 30, 2014.

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 \$3.8 million or 0.64% of total assets at September 30, 2015, as compared with \$2.6 million or 0.43% of total assets at December 31, 2014, and \$3.6 million or 0.62% of total assets at September 30, 2014. Nonaccrual loans totaled \$2.3 million or 0.50% of total loans at September 30, 2015 compared with \$1.2 million or 0.28% of total loans at December 31, 2014, and \$2.2 million or 0.51% of total loans at September 30, 2014. Total loans classified as substandard and doubtful were \$19.5 million and \$59,000, respectively, at September 30, 2015, \$24.9 million and \$59,000, respectively, at December 31, 2014 and \$28.0 million and \$58,000, respectively, at September 30, 2014. During the nine months ended September 30, 2015, there were net charge-offs of \$815,000 or 0.18% of total average loans compared with net recoveries of \$72,000 or 0.02% of total average loans for the same nine months of 2014. There was a \$200,000 provision for loan losses for the first nine months of 2015 compared with no provision for the first nine months of 2014. Total allowance for loan losses was \$4.8 million or 1.03% of total loans at September 30, 2015 compared with \$5.4 million or 1.22% of loans at December 31, 2014 and \$6.6 million or 1.51% of loans at September 30, 2014. The declining trend in the allowance for loan losses reflects the declining trend in impaired loans' specific reserves, and loans classified as substandard or doubtful over the same time periods.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2015 AND 2014

NET INCOME

Net income of \$1.35 million for the quarter ended September 30, 2015 was a 5.3% decrease from the net income for the quarter ended September 30, 2014 of \$1.42 million. Earnings per share on a fully diluted basis were \$0.36 for the third quarter of 2015 compared with \$0.38 for the third quarter of 2014. Profitability as measured by return on average assets decreased from 0.95% in the third quarter of 2014 to 0.90% for the same period in 2015. Profitability as measured by return on average equity decreased from 10.43% to 9.40% over the same respective quarters in 2014 and 2015. The decrease in net income was primarily due to an increase of \$191,000 in total other expenses, as well as the \$100,000 increase in the provision for loan losses in the third quarter of 2015 compared with the third quarter of 2014, partially offset by the \$121,000 increase in net interest income and \$140,000 decrease in income tax expense over the same periods.

NET INTEREST INCOME AND EXPENSE

Net interest income increased \$121,000 or 2.5% to \$5.01 million for the quarter ended September 30, 2015 from \$4.89 million for the quarter ended September 30, 2014. The increase in net interest income was due to the decrease in interest on deposits. The Company's net interest margin increased from 3.58% in the third quarter of 2014 to 3.69% in the third quarter of 2015.

Total interest income decreased \$66,000 or 1.2% to \$5.46 million for the third quarter of 2015 from \$5.53 million for the third quarter of 2014. This decrease was primarily due to the decline in the yield on earning assets from 4.04% during the third quarter of 2014 to 4.02% during the third quarter of 2015.

The tax-equivalent average yield on loans was 4.42% for the third quarter of 2015, down from 4.63% in the third quarter of 2014. Average loan balances increased \$17.4 million or 4.0% from \$440.5 million during the third quarter of 2014 to \$457.9 million during the third quarter of 2015. The decrease in the tax-equivalent average yield on loans resulted in a \$39,000 or 0.8% decrease in interest and fee income from loans for the third quarter of 2015, compared with the same period in 2014. On a tax equivalent basis, interest and fee income on loans decreased \$40,000 or 0.8%.

Average investment security balances decreased \$202,000 from \$58.8 million in the third quarter of 2014 to \$58.5 million in the third quarter of 2015. The tax-equivalent average yield on investments decreased from 2.72% for the third quarter of 2014 to 2.65% for the third quarter of 2015. Interest and dividend income on security investments decreased \$8,000, from \$367,000 for the third quarter of 2014 to \$359,000 for the third quarter of 2015.

Approximately \$17,000 of interest income on securities was due to the receipt and recognition of past due interest on the Bank's investment in trust preferred securities. For further discussion on trust preferred securities, see "Securities" in Note 2 of the Notes to Consolidated Financial Statements contained herein. Interest income on deposits in other banks decreased \$19,000 from third quarter 2014 to third quarter 2015 resulting from a \$21.1 million decrease in average interest-bearing balances held at the Federal Reserve.

Total interest expense decreased \$187,000 or 29.4% from \$635,000 for the third quarter of 2014 to \$448,000 for the third quarter of 2015 primarily due to the decline in rate and average balances of time deposits.

Interest paid on deposits decreased \$193,000 or 38.4% from \$502,000 for the third quarter of 2014 to \$309,000 for the third quarter of 2015. Average balances on time deposits declined \$29.2 million or 30.9% from \$94.6 million to \$65.3 million while the average rate decreased from 1.45% for the third quarter of 2014 to 0.92% for the third quarter of 2015, resulting in \$195,000 less interest expense. Average money market account balances increased \$2.6 million from the third quarter of 2014 to the third quarter of 2015 while the rate was constant at 0.21%, resulting in an increase of \$2,000 in interest expense. Average savings account balances increased \$7.5 million or 9.9% from the third quarter of 2014 to the third quarter of 2015, and the average rate remained constant at 0.10%, resulting in an increase of \$2,000 of interest expense for the third quarter of 2015. Average interest bearing checking balances

increased \$1.3 million or 0.6% from the third quarter of 2014 to the third quarter of 2015, while the average rate was 0.21% for both periods, resulting in a decrease of \$2,000 in checking interest expense for the third quarter of 2015.

Interest expense on FHLB advances was \$82,000 and \$83,000 for each of the three months ended September 30, 2015 and 2014, respectively. Interest expense on capital securities was \$50,000 for the each of the third quarters of 2014 and 2015.

The average rate on total interest-bearing liabilities decreased from 0.57% in the third quarter of 2014 to 0.41% for the third quarter of 2015.

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.

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Average Balances, Income and Expense, and Average Yields and Rates

(Dollars in thousands)	Three Months Ended September 30, 2015				Three Months Ended September 30, 2014			
	Average Balances	Income/ Expense	Average Rate		Average Balances	Income/ Expense	Average Rate	
<b>Assets</b>								
<b>Loans</b>								
Taxable	\$451,188	\$ 5,021	4.42	%	\$432,447	\$ 5,057	4.64	%
Tax-exempt (1)	5,852	83	5.62	%	5,898	87	5.82	%
Nonaccrual (2)	904	-	0.00	%	2,181	-	0.00	%
Total Loans	457,944	5,104	4.42	%	440,526	5,144	4.63	%
<b>Securities</b>								
Taxable	52,754	306	2.32	%	52,085	306	2.36	%
Tax-exempt (1)	5,794	81	5.58	%	6,665	93	5.59	%
Total securities	58,548	387	2.65	%	58,750	399	2.72	%
Deposits in banks	28,862	26	0.36	%	49,930	45	0.35	%
Federal funds sold	8	-	0.14	%	12	-	0.16	%
Total earning assets	545,362	5,517	4.02	%	549,218	\$ 5,588	4.04	%
Less: Reserve for loan losses	(4,671	)			(6,756	)		
Cash and due from banks	5,145				4,977			
Bank premises and equipment, net	20,716				20,455			
Other real estate owned	1,805				1,406			
Other assets	25,404				25,130			
Total Assets	\$593,761				\$594,430			
<b>Liabilities and Shareholders' Equity</b>								
<b>Deposits</b>								
Demand deposits	\$99,412				\$91,124			
<b>Interest-bearing deposits</b>								
Checking accounts	205,637	\$ 108	0.21	%	204,323	\$ 110	0.21	%
Money market accounts	51,974	28	0.21	%	49,333	26	0.21	%
Savings accounts	83,296	22	0.10	%	75,824	20	0.10	%
Time deposits	65,318	151	0.92	%	94,559	346	1.45	%
Total interest-bearing deposits	406,225	309	0.30	%	424,039	502	0.47	%
Federal funds purchased	5,607	7	0.53	%	-	-	0.00	%
Federal Home Loan Bank advances	13,033	82	2.49	%	13,099	83	2.49	%
Capital securities of subsidiary trust	4,124	50	4.83	%	4,124	50	4.83	%
Total interest-bearing liabilities	428,989	448	0.41	%	441,262	635	0.57	%
Other liabilities	8,527				7,965			
Shareholders' equity	56,833				54,079			
Total Liabilities & Shareholders' Equity	\$593,761				\$594,430			
Net interest spread		\$ 5,069	3.61	%		\$ 4,953	3.47	%
			0.33	%			0.46	%

Interest expense as a percent of average earning  
assets

Net interest margin

3.69 %

3.58 %

- (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.

35

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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, 2015 Compared to Three Months Ended September 30, 2014		
	Change	Due to Volume	Due to Rate
Interest Income			
Loans; taxable	\$(36)	\$ 219	\$(255)
Loans; tax-exempt (1)	(4 )	(1 )	(3 )
Securities; taxable	0	4	(4 )
Securities; tax-exempt (1)	(12)	(12 )	-
Deposits in banks	(19)	(19 )	-
Federal funds sold	-	-	-
Total Interest Income	(71)	191	(262)
Interest Expense			
Checking accounts		(2 )	1 (3 )
Money market accounts		2	1 1
Savings accounts		2	2 -
Time deposits		(195)	(88 ) (107)
Federal funds purchased and securities sold under agreements to repurchase		7	7 -
Federal Home Loan Bank advances		(1 )	(1 ) -
Capital securities of subsidiary trust		-	- -
Total Interest Expense		(187)	(78 ) (109)
Net Interest Income		\$116	\$269 \$(153)

(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

There was a \$100,000 provision for loan losses made during the third quarter of 2015 compared with no provision for the third quarter of 2014. The amount of the provision for loan loss is 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. 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 \$100,000 increase in the provision for loan losses primarily reflects the growth in outstanding loans, partially offset by the declining trend in impaired loans and loans classified as substandard or doubtful over the same periods. The change allocation of the provision among loan categories is due to reevaluation of impairment on specific loans, the decline of specified impaired residential real estate loans, and varying degrees of loan growth, payoffs and chargeoffs within categories.

### OTHER INCOME

Total other income decreased by \$46,000 or 2.4% for the third quarter of 2015 from \$1.93 million in the third quarter of 2014. 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 decrease in other income was partially due to a \$64,000 decrease in service charges on deposit accounts during the third quarter of 2015 compared with the third quarter of 2014.

Trust and estate income increased \$9,000 or 1.9% from the third quarter of 2014 to the third quarter of 2015 primarily due to increased growth of managed investment accounts. Future trust and estate income may be negatively impacted by the resignation of two investment management personnel during September 2015. Management believes that there may be a reduction in managed investment accounts and related assets as result of their resignation, but the Bank cannot quantify the impact at this time.

Brokerage service revenues decreased from \$83,000 for the third quarter of 2014 to \$42,000 for the third quarter of 2015 due to changes in the investment mix of investment products sold during 2014 compared with 2015.

Service charges on deposit accounts decreased \$64,000 or 9.7% to \$598,000 for the third quarter of 2015 compared to one year earlier. The reason for the change is difficult to determine, but may be due to changes in consumer behavior in their personal funds management because of greater access to account information via mobile technology. Other reasons which may have contributed to the decline in service charges on deposit accounts include the decline in gas prices, which reduced consumers overall expenditures and increased the relative level of their deposit accounts.

Other service charges, commissions and fees increased \$47,000 or 6.6% from \$712,000 in third quarter of 2014 to \$759,000 in the third quarter of 2015 due to debit card interchange income, net, which totaled \$310,000 and \$246,000 for the third quarters of 2015 and 2014, respectively. Also included in other service charges, commissions, and fees are revenues on bank owned life insurance ("BOLI") and the recognition of passive investment losses on community development tax credit programs. During the third quarter of 2015, noninterest income included the receipt of approximately \$433,000 in tax-free death benefit in excess of surrender value related to BOLI compared with the receipt of approximately \$300,000 in tax-free death benefit in excess of surrender value related to BOLI in third quarter 2014. Additionally, during the 2015 quarter, \$155,000 of passive tax losses on community development tax credit programs were recognized, while in third quarter 2014, no passive losses were recognized.



#### OTHER EXPENSE

Total other expense increased \$191,000 or 3.8% during the third quarter of 2015 compared with the third quarter of 2014, primarily due to the increase in salaries and benefits expenses, as well as an increase in legal and consulting expense.

Salaries and employees' benefits increased \$73,000 or 2.7% from third quarter 2014 to third quarter 2015. The increase was primarily due to the annual increases in salaries for the third quarter of 2015 compared with the third quarter of 2014. Additionally, active full-time equivalent employees increased from 140 as of September 30, 2014 to 149 as of September 30, 2015.

Occupancy expense increased \$7,000 or 1.3%.

Furniture and equipment expense increased \$16,000 or 6.1%, from third quarter 2014 to third quarter 2015 due to depreciation on teller data capture equipment.

Marketing expense increased \$21,000 or 13.9% from the third quarter of 2014 to \$172,000 for the third quarter of 2015, primarily due to increases in advertising and business development.

Legal, auditing and consulting expense increased \$55,000 or 23.4% from the third quarter of 2014 to \$290,000 for the third quarter of 2015 primarily due to consulting expenses associated with the previously announced succession process for the Company's and Bank's chief executive officer.

Data processing expense decreased \$74,000 or 20.2% for the third quarter of 2015 compared with the same time period in 2014 due to the renegotiation of the Bank's contract with its third-party core data processing provider.

FDIC deposit insurance expense increased \$7,000 from \$94,000 for the third quarter of 2014 to \$101,000 for the third quarter of 2015.

Other operating expenses increased \$112,000 or 16.6% in the third quarter of 2015 compared with the third quarter of 2014 due to a variety of factors, including an increase in non-loan chargeoffs. During the third quarter of 2015, the Bank charged off approximately \$62,000 due to check fraud/identity theft, compared with \$22,000 during the same quarter in 2014 .

#### INCOME TAXES

Income tax expense was \$238,000 for the quarter ended September 30, 2015 compared with \$378,000 for the quarter ended September 30, 2014. The effective tax rate was 15.0% and 21.0% for the third quarters of 2015 and 2014, 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 death benefit, and community development tax credits.

COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2015 AND 2014

NET INCOME

Net income of \$3.14 million for the nine months ended September 30, 2015 was a 14.1% decrease from the net income for the nine months ended September 30, 2014 of \$3.65 million. Earnings per share on a fully diluted basis were \$0.84 for the nine months ended September 30, 2015 compared with \$0.98 for the nine months ended September 30, 2014. Profitability as measured by return on average assets decreased from 0.82% in the nine months ended September 30, 2014 to 0.70% for the same period in 2015. Profitability as measured by return on average equity decreased from 9.21% to 7.47% over the same respective nine months in 2014 and 2015. The decrease in net income was primarily due to the \$722,000 increase in total other expenses, as well as the \$195,000 decrease in total other income, and the \$200,000 increase in the provision for loan losses for the nine months ended September 30, 2015 compared with the nine months ended September 30, 2014. This was partially offset by the \$164,000 increase in net interest income and \$437,000 decrease in income tax expense.

NET INTEREST INCOME AND EXPENSE

Net interest income increased \$164,000 or 1.1% to \$14.73 million for the nine months ended September 30, 2015 from \$14.57 million for the nine months ended September 30, 2014. The increase in net interest income was due primarily to the decline in cost of time deposits. The Company's net interest margin increased from 3.58% for the nine months ended September 30, 2014 to 3.63% for the nine months ended September 30, 2015.

Total interest income decreased \$255,000 or 1.5% to \$16.26 million for the nine months ended September 30, 2015 from \$16.51 million for the nine months ended September 30, 2014. This decrease was primarily due to a four basis point decline in the yield on average earning assets over the respective time periods on a tax equivalent basis.

The tax-equivalent average yield on loans was 4.50% for the nine months ended September 30, 2015, down from 4.62% during the same time period in the prior year. Average loan balances increased \$5.5 million or 1.2% to \$450.2 million during the nine months ended September 30, 2015 from \$444.7 million during the nine months ended September 30, 2014. The decrease in yield, partially offset by the increase in average balances, resulted in a \$183,000 or 1.2% decline in interest and fee income from loans for the nine months ended September 30, 2015 compared with the same period in 2014. On a tax equivalent basis, the decrease in interest and fee income on loans was \$204,000 or 1.3%.

Average investment security balances increased \$1.0 million from \$56.9 million for the nine months ended September 30, 2014 to \$58.0 million in the nine months ended September 30, 2015. The tax-equivalent average yield on investments decreased from 2.88% to 2.70% over the same respective time periods. Interest and dividend income on security investments decreased \$45,000 or 4.0%, from \$1.13 million for the nine months ended September 30, 2014 to \$1.09 million for the nine months ended September 30, 2015. On a tax equivalent basis, the decrease was \$54,000 or 4.4%. Approximately \$87,000 of the increase in interest income on securities was due to the receipt and recognition of past due interest on the Bank's investment in trust preferred securities. For further discussion on trust preferred securities, see "Securities" in Note 2 of the Notes to Consolidated Financial Statements contained herein.

Interest income on deposits in other banks decreased \$27,000 from \$126,000 to \$99,000 over the first nine months of 2015 compared with the same period in the prior year primarily due to a \$9.4 million decline in average balances.

Total interest expense decreased \$419,000 or 21.6% from \$1.94 million for the nine months ended September 30, 2014 to \$1.52 million for the nine months ended September 30, 2015, primarily due to the decline in interest paid on time deposits.

Interest paid on deposits decreased \$424,000 or 27.4% from \$1.55 million for the nine months ended September 30, 2014 to \$1.13 million for the nine months ended September 30, 2015. Average balances on time deposits declined

\$25.5 million or 25.5% from \$100.1 million to \$74.6 million while the average rate increased from 1.45% to 1.70% from the nine months ended September 30, 2014 to the nine months ended September 30, 2015, resulting in \$430,000 less interest expense. Average money market accounts increased \$3.1 million or 6.2% from the nine months ended September 30, 2014 to the nine months ended September 30, 2015 while the rate was constant for both periods at 0.21%, resulting in \$8,000 additional interest expense. Average savings account balances increased \$5.1 million from the nine months ended September 30, 2014 to the nine months ended September 30, 2015, while their average rate declined from 0.11% to 0.10% over the same respective periods, resulting in \$1,000 of additional interest expense for the nine months ended September 30, 2015. Average interest bearing checking balances increased \$5.4 million from the nine months ended September 30, 2014 to the nine months ended September 30, 2015, while the average rate decreased from 0.22 % to 0.21%, resulting in a decrease of \$3,000 in checking interest expense.

Interest expense on FHLB advances decreased \$2,000 due to a decrease in average balances of \$66,000 from the first nine months of 2014 to the first nine months of 2015. Interest expense on capital securities was \$149,000 for both the nine months ended September 30, 2015 and 2014.

The average rate on total interest-bearing liabilities decreased from 0.58% for the nine months ended September 30, 2014 to 0.47% for the nine months ended September 30, 2015.

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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, 2015			Nine Months Ended September 30, 2014		
	Average Balances	Income/ Expense	Average Rate	Average Balances	Income/ Expense	Average Rate
<b>Assets</b>						
<b>Loans</b>						
Taxable	\$442,849	\$14,899	4.50 %	\$435,903	\$15,041	4.61 %
Tax-exempt (1)	6,132	262	5.72 %	6,591	324	6.58 %
Nonaccrual (2)	1,199	-	0.00 %	2,226	-	0.00 %
Total Loans	450,180	15,161	4.50 %	444,720	15,365	4.62 %
<b>Securities</b>						
Taxable	51,933	922	2.37 %	50,290	949	2.52 %
Tax-exempt (1)	6,032	252	5.56 %	6,632	279	5.61 %
Total securities	57,965	1,174	2.70 %	56,922	1,228	2.88 %
<b>Deposits in banks</b>						
Federal funds sold	40,176	99	0.33 %	49,554	126	0.34 %
Total earning assets	9	-	0.16 %	11	-	0.18 %
	548,330	\$16,434	4.01 %	551,207	\$16,719	4.05 %
<b>Less: Reserve for loan losses</b>						
	(5,171 )			(6,961 )		
<b>Cash and due from banks</b>						
	5,284			5,034		
<b>Bank premises and equipment, net</b>						
	20,887			19,518		
<b>Other real estate owned</b>						
	1,542			2,148		
<b>Other assets</b>						
	25,521			25,087		
Total Assets	\$596,393			\$596,033		
<b>Liabilities and Shareholders' Equity</b>						
<b>Deposits</b>						
Demand deposits	\$94,733			\$88,426		
<b>Interest-bearing deposits</b>						
Checking accounts	209,273	\$327	0.21 %	203,893	\$330	0.22 %
Money market accounts	52,730	84	0.21 %	49,647	76	0.21 %
Savings accounts	81,301	62	0.10 %	76,215	61	0.11 %
Time deposits	74,562	652	1.70 %	100,074	1,082	1.45 %
Total interest-bearing deposits	417,866	1,125	0.36 %	429,829	1,549	0.48 %
<b>Federal funds purchased</b>						
	1,892	7	0.53 %	3	-	0.75 %
<b>Federal Home Loan Bank advances</b>						
	13,049	243	2.49 %	13,115	245	2.49 %
<b>Capital securities of subsidiary trust</b>						
	4,124	149	4.83 %	4,124	149	4.83 %
Total interest-bearing liabilities	436,931	1,524	0.47 %	447,071	1,943	0.58 %

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Other liabilities	8,556	7,470
Shareholders' equity	56,173	53,066
Total Liabilities & Shareholders' Equity	\$596,393	\$596,033

Net interest spread	\$14,910	3.54	%	\$14,776	3.47	%
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Interest expense as a percent of average earning assets

	0.37	%	0.47	%
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Net interest margin	3.63	%	3.58	%
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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, 2015 Compared to Nine Months Ended September 30, 2014		
	Change	Due to Volume	Due to Rate
Interest Income			
Loans; taxable	\$ (142)	\$ 239	\$ (381)
Loans; tax-exempt (1)	(62 )	(22 )	(40 )
Securities; taxable	(27 )	30	(57 )
Securities; tax-exempt (1)	(27 )	(25 )	(2 )
Deposits in banks	(27 )	(24 )	(3 )
Federal funds sold	-	-	-
Total Interest Income	(285)	198	(483)
Interest Expense			
Checking accounts	(3 )	9	(12 )
Money market accounts	8	6	2
Savings accounts	1	3	(2 )
Time deposits	(430)	(276 )	(154)
Federal funds purchased	7	7	-
Federal Home Loan Bank advances	(2 )	(2 )	-
Capital securities of subsidiary trust	-	-	-
Total Interest Expense	(419)	(253 )	(166)
Net Interest Income	\$ 134	\$ 451	\$ (317)

(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 for the nine months ended September 30, 2015 was \$200,000 compared with no provision for the nine months ended September 30, 2014. The amount of the provision for loan loss is 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. 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 \$200,000 increase in the provision for loan losses primarily reflects the growth in outstanding loans, partially offset by the declining trend in impaired loans, specific reserves and loans classified as substandard or doubtful over the same time periods. The change allocation of the provision among loan categories is due to reevaluation of impairment on specific loans, the decline of specified impaired residential real estate loans, and varying degrees of loan growth, payoffs and chargeoffs within categories.

#### OTHER INCOME

Total other income decreased by \$195,000 or 3.9% from \$5.05 million for the nine months ended September 30, 2014 to \$4.86 million for the nine months ended September 30, 2015. The decrease was primarily due to the 2014 period to 2015 period decline in service charges on deposit accounts of \$200,000. In addition, brokerage income declined \$56,000 and other service charges, commissions and income declined \$28,000 from the nine months ended September 30, 2014 to the nine months ended September 30, 2015 primarily due to the increase in the recognition of passive losses within community development tax credit investments.

Trust and estate income increased \$86,000 or 6.4% from the first nine months of 2014 to the first nine months ended September 30, 2015 due to increased growth of managed investment accounts.

Brokerage service revenues decreased \$56,000 or 23.0% from the first nine months of 2014 to the first nine months of 2015 due to changes in the mix of investment products sold during 2014 compared with 2015.

Service charges on deposit accounts decreased \$200,000 or 10.4% to \$1.73 million for the nine months ended September 30, 2015 compared to the same period one year earlier. The reason for the change is difficult to determine, but may be due to changes in consumer behavior in their personal funds management because of greater access to account information via mobile technology. Other reasons which may have contributed to the decline in service charges on deposit accounts include the decline in gas prices, which reduced consumers overall expenditures and increased the relative level of their deposit accounts.

Other service charges, commissions and fees decreased \$28,000 or 1.8% from \$1.53 million during the nine months ended September 30, 2014 to \$1.50 million during the nine months ended September 30, 2015, primarily due to the recognition of passive losses within community development tax credit investments. These losses were \$430,000 in the first nine months of 2015 compared with \$180,000 in the first nine months of 2014. These passive losses will be more than offset in future periods by federal tax credits related to low/moderate income housing and/or buildings of historical significance. Also included in other service charges, commissions, and income is ATM/debit card interchange income which totaled \$933,000 and \$823,000 for the first nine months of 2015 and 2014, respectively. Also included is BOLI income, which was \$703,000, including approximately \$433,000 of tax-free death benefit in excess of surrender value, during the nine months ended September 30, 2015, compared with \$584,000 one year earlier that included approximately \$300,000 in tax-free death benefit in excess of surrender value.

#### OTHER EXPENSE

Total other expense increased \$722,000 or 4.9% during the nine months ended September 30, 2015 compared with the nine months ended September 30, 2014. The increase was primarily due to increased expenses related to salaries and benefits; occupancy expenses; legal, audit and consulting expense; and costs related to other real estate owned ("OREO").

Salaries and employees' benefits increased \$208,000 or 2.7% from the nine months ended September 30, 2014 to the nine months ended September 30, 2015. The increase was primarily due to the annual increases in salaries for the first nine months of 2015 compared to 2014. Additionally, active full-time employees increased from 140 as of September 30, 2014 to 149 as of September 30, 2015.

Occupancy expense increased \$79,000 or 4.7%, while furniture and equipment expense increased \$119,000 or 14.9%, for the nine months ended September 30, 2015 compared with the nine months ended September 30, 2014.

Marketing expense increased \$22,000 or 5.1% from the nine months ended September 30, 2014 to \$456,000 for the nine months ended September 30, 2015.

Legal, accounting and consulting expense increased \$220,000 or 34.8% from the nine months ended September 30, 2014 to \$852,000 for the nine months ended September 30, 2015 primarily due to consulting expenses associated with the previously announced succession process for the Company's and Bank's chief executive officer and other strategic planning issues.

Data processing expense decreased \$128,000 or 11.9% for the nine months ended September 30, 2015 compared with the same time period in 2014 due to the renegotiation of the Bank's contract with its third-party core data processing provider.

FDIC deposit insurance expense increased \$15,000 or 5.4% from \$279,000 for the nine months ended September 30, 2014 to \$294,000 for the nine months ended September 30, 2015 due to changes in the qualitative factors used to calculate FDIC expense.

Net gain on sale or impairment and expense on OREO increased \$91,000 for the first nine months of 2015 compared with the same period one year earlier due to a gain of \$130,000 on the sale of one property during 2014.

Other operating expenses increased \$96,000 or 4.2% in the nine months ended September 30, 2015 compared with the nine months ended September 30, 2014 due to a variety of factors, but primarily the increase in non-loan chargeoffs.

#### INCOME TAXES

Income tax expense was \$674,000 for the nine months ended September 30, 2015 and \$1.1 million for the nine months ended September 30, 2014. The effective tax rate was 17.7% and 23.3% for the first nine months of 2015 and 2014, 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 death benefit, and community development tax credits.



COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2015 AND DECEMBER 31, 2014

Total assets were \$594.2 million at September 30, 2015 compared with \$606.3 million at December 31, 2014, a decrease of 2.0% or \$12.1 million. Balance sheet categories reflecting significant changes include interest-bearing deposits in other banks, loans, OREO, and deposits. Each of these categories is discussed below.

**INTEREST-BEARING DEPOSITS IN OTHER BANKS.** Interest-bearing deposits in other banks were \$23.9 million at September 30, 2015, a decrease of \$33.7 million from December 31, 2014. The reduction in this account is primarily due to the increase in loans outstanding and the decrease in deposits, both reducing the amount of excess liquidity in the Bank.

**LOANS, NET.** Loans, net of allowance for loan losses, were \$460.7 million at September 30, 2015, reflecting an increase of \$25.6 million or 5.9 % from \$435.1 million at December 31, 2014.

**OTHER REAL ESTATE OWNED, NET.** Other real estate owned, net, increased \$118,000 to \$1.5 million at September 30, 2015 due to the foreclosure of two single-family residential properties and the subsequent sale of one property that resulted in a gain of \$34,000. The remaining OREO consists of 47 acres of undeveloped land in Opal, Virginia

**DEPOSITS.** For the nine months ended September 30, 2015, total deposits decreased by \$14.1 million or 2.7% when compared with total deposits at December 31, 2014. Non-interest-bearing deposits increased \$12.1 million to \$100.0 million, while interest-bearing deposits decreased by \$26.2 million to \$411.1 million at September 30, 2015 from December 31, 2014. Included in interest-bearing deposits at both September 30, 2015 and December 31, 2014 were \$20.8 million of brokered deposits as defined by the Federal Reserve. Of the \$20.8 million in brokered deposits, \$13.2 million represent deposits of Bank customers, exchanged through the CDARS and ICS networks. With the CDARS and ICS programs, funds are placed into certificate of deposits or money market accounts 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 decrease in the Bank's interest-bearing deposits during the first nine months of 2015 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 2015 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.

**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.

Non-performing assets totaled \$3.8 million or 0.64% of total assets at September 30, 2015, compared with \$2.6 million or 0.43% of total assets at December 31, 2014, and \$3.6 million or 0.62% of total assets at September 30, 2014. There were no non-performing pooled trust preferred bonds at September 30, 2015 and non-performing assets were comprised solely of \$1.5 million of OREO and \$2.3 million of non-accrual loans. Non-accrual loans as a percentage of total loans were 0.50% at September 30, 2015, as compared with 0.28% and 0.51% at December 31, 2014 and September 30, 2014, respectfully, primarily as the result of the addition of four loans to a single borrower which was partially offset by loans moving to performing status or paying off.

Student loans that were past due 90 days or more and still accruing interest totaled \$2.9 million at September 30, 2015, \$4.6 million at December 31, 2014 and \$4.1 million at September 30, 2014. 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. There were no other loans that were past due 90 days or more and still accruing interest at September 30, 2015, December 31, 2014 and September 30, 2014. During the quarter ended September 30, 2015, there were no loans newly identified as TDRs. At the end of the quarter, 12 TDRs, totaling \$7.1 million, were in the loan portfolio. Seven of the loans, totaling \$5.2 million, were on accrual status and performing in accordance with the modified terms. The remaining five loans, totaling \$1.9 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.

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, 2015, 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, 2015 was approximately \$18.1 million of loans to customers in the childcare industry, or 3.9% of total gross loans and 28.3% of risk-based capital.

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, 2015, commercial construction and land loans were \$37.2 million or 58.4% of the concentration limit. Commercial investor real estate loans, including commercial construction and land loans, were \$137.1 million or 215.0% of the concentration guideline.

#### CONTRACTUAL OBLIGATIONS

As of September 30, 2015, 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, 2014.

#### OFF-BALANCE SHEET ARRANGEMENTS

As of September 30, 2015, 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, 2014.

#### CAPITAL

The Company meets the eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board's Small Bank Holding Company Policy Statement issued in February 2015, and is no longer obligated to report consolidated regulatory capital. The Bank continues to be subject to various 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 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 Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. In July 2013, the Federal Reserve issued final rules that make technical changes to its capital rules to align them with the Basel III regulatory capital framework and meet certain requirements of the Dodd-Frank Act. The final rules maintain the general structure of the prompt corrective action framework in effect at such time while incorporating certain increased minimum requirements. Effective January 1, 2015, the final rules require the Bank to comply with the following minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of

6.0% of risk-weighted assets (increased from the prior requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4.0% of total assets (unchanged from the prior requirement). These are the initial capital requirements, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Bank to maintain such minimum ratios plus a 2.5% "capital conservation buffer" (other than for the leverage ratio). The capital conservation buffer requirement will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. Management believes the Bank will be compliant with the fully phased-in requirements when they become effective January 1, 2019.

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The following table provides information on the regulatory capital ratios for the Bank at September 30, 2015 and December 31, 2014. Management believes that the Bank exceeds all capital adequacy requirements of Basel III, including the conservation buffer, as of September 30, 2015.

Risk Based Capital Ratios

	September 30, 2015	December 31, 2014		
(Dollars in thousands)				
Tier 1 Capital:				
Common Equity	\$ 59,184	\$ 57,093		
Less: Unrealized loss on securities available for sale, net	155	161		
Less: Accumulated net loss on supplemental retirement plans	(62 )	(62 )		
Total Tier 1 Capital	59,091	56,994		
Tier 2 Capital:				
Allowable allowance for loan losses	4,776	5,391		
Unrealized loss on equity securities, net	3	-		
Total Capital:	\$ 63,870	\$ 62,385		
Risk Weighted Assets:	\$ 490,435	\$ 443,908		
Regulatory Capital Ratios:				
Leverage Ratio	9.98	%	9.48	%
Common Equity Tier 1 Capital Ratio	12.05	%	NA	
Tier 1 Capital Ratio	12.05	%	12.84	%
Total Capital Ratio	13.02	%	14.05	%

CAPITAL RESOURCES AND LIQUIDITY

Shareholders' equity totaled \$57.1 million at September 30, 2015 compared with \$55.2 million at December 31, 2014 and \$54.6 million at September 30, 2014. The amount of equity reflects management's desire to increase shareholders' return on equity while maintaining a strong capital base. On January 22, 2015, the Company's Board of Directors authorized the Company to repurchase up to 111,926 shares (3% of common stock outstanding on January 1, 2015) beginning January 1, 2015 and continuing until the next Board reset. No shares were repurchased during the nine months ended September 30, 2015. Accumulated other comprehensive income/loss was an unrealized loss, net of tax benefit, of \$146,000 at September 30, 2015 compared with an unrealized loss, net of tax benefit, of \$101,000 at December 31, 2014 and \$136,000 at September 30, 2014.

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, 2015, 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. 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.

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled \$29.5 million at September 30, 2015 compared with \$64.4 million at December 31, 2014. 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 \$5.8 million was unpledged and readily salable at September 30, 2015. Furthermore, the Bank has an available line of credit with the FHLB with a borrowing limit of approximately \$99.1 million at September 30, 2015 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 \$65.1 million. At September 30, 2015, \$13.0 million of the FHLB 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, 2015 and December 31, 2014. 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, 2015			December 31, 2014			
	Total	In Use	Available	Total	In Use	Available	
<b>Sources:</b>							
Federal funds borrowing lines of credit	\$65,085	\$-	\$65,085	\$60,302	\$-	\$60,302	
Federal Home Loan Bank advances	99,146	13,025	86,121	143,712	13,075	130,637	
Federal funds sold and interest-bearing deposits in other banks, excluding requirements			4,874			35,756	
Securities, available for sale and unpledged at fair value			5,764			6,290	
Total short-term funding sources			\$161,844			\$232,985	
<b>Uses:</b>							
Unfunded loan commitments and lending lines of credit			\$74,207			\$82,308	
Letters of credit			2,516			3,349	
Total potential short-term funding uses			\$76,723			\$85,657	
Ratio of short-term funding sources to potential short-term funding uses			210.9	%		272.0	%

#### 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 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, 2014.

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, 2015.

Part II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

Not applicable to smaller reporting companies.

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

On January 22, 2015, the Company's Board of Directors authorized the Company to repurchase up to 111,926 shares (3% of common stock outstanding on January 1, 2015 beginning January 1, 2015 and continuing until the next Board reset. No shares were repurchased during the three month period ended September 30, 2015.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

48

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Exhibit Exhibit

NumberDescription

- 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, 2015, formatted in XBRL: (1) Consolidated Balance Sheets, (2) Consolidated Statements of Income, (3) Consolidated Statements of Comprehensive Income, (4) Consolidated Statements 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 13, 2015

/s/ Eric P. Graap

Eric P. Graap  
Executive Vice President & Chief Financial Officer  
Dated: November 13, 2015