

FAUQUIER BANKSHARES, INC.  
Form 10-K  
March 11, 2011

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

(Mark One)

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

For the fiscal year ended December 31, 2010

or

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

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

Commission File No.: 000-25805

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

Virginia 54-1288193  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

10 Courthouse Square, Warrenton, Virginia 20186  
(Address of principal executive offices) (Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class                      | Name of each exchange on which registered              |
|--|--|
| Common Stock, par value \$3.13 per share | The NASDAQ Stock Market LLC<br>(NASDAQ Capital Market) |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.  
Yes  No

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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 Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 aggregate market value of the registrant's common shares held by "non-affiliates" of the registrant, based upon the closing sale price of its common stock on the NASDAQ Capital Market on June 30, 2010, was \$53.4 million. Shares held by each executive officer, director and holder of 10% or more of the registrant's outstanding common stock have been excluded as shares held by affiliates. Such determination of affiliate status is not a conclusive determination for other purposes.

The registrant had 3,669,758 shares of common stock outstanding as of March 10, 2011.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the 2011 Annual Meeting of Shareholders to be held on May 17, 2011 are incorporated by reference into Part III of this Form 10-K.

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PART I

ITEM 1. BUSINESS

GENERAL

Fauquier Bankshares, Inc. (“the Company”) was incorporated under the laws of the Commonwealth of Virginia on January 13, 1984. The Company is a registered bank holding company and owns all of the voting shares of The Fauquier Bank (“the Bank”). The Company engages in its business through the Bank, a Virginia state-chartered bank that commenced operations in 1902. The Company has no significant operations other than owning the stock of the Bank. The Company had issued and outstanding 3,636,758 shares of common stock, par value \$3.13 per share, held by approximately 421 holders of record on December 31, 2010. The Bank has ten full service branch offices located in the Virginia communities of Warrenton, Catlett, The Plains, Sudley Road-Manassas, Old Town-Manassas, New Baltimore, Bealeton, Bristow, and Haymarket. The executive offices of the Company and the main office of the Bank are located at 10 Courthouse Square, Warrenton, Virginia 20186.

THE FAUQUIER BANK

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: non-interest bearing demand deposit accounts, money market deposit accounts, NOW accounts, time deposits, safe deposit services, credit cards, cash management, direct deposits, notary services, night depository, travel and gift cards, cashier’s checks, domestic collections, savings bonds, bank drafts, automated teller services, drive-in tellers, internet banking, telephone banking, and banking by mail. In addition, the Bank makes secured and unsecured commercial and real estate loans, issues stand-by letters of credit and grants available credit for installment, unsecured and secured personal loans, residential mortgages and home equity loans, as well as automobile and other types of consumer financing. The Bank provides automated teller machine (“ATM”) cards, as a part of the Cirrus, Accel-Exchange and Plus networks, thereby permitting customers to utilize the convenience of larger ATM networks.

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. During 2010, assets managed by WMS increased by \$2.0 million in market value to \$312.8 million when compared with 2009, with revenue increasing from \$1.11 million to \$1.45 million or 30.5%, over the same time period. The increase in revenue was primarily due to the full year average increase in valuations of common stock under management during 2010 compared with 2009.

The Bank, through its subsidiary Fauquier Bank Services, Inc., has equity ownership interests in Bankers Insurance, LLC, a Virginia independent insurance company; Infinex Investments, Inc., a full service broker/dealer; and Bankers Title Shenandoah, LLC, a title insurance company. Bankers Insurance consists of a consortium of Virginia community bank owners; Infinex is owned by banks in various states; and Bankers Title Shenandoah is owned by Virginia community banks. On April 30, 2008, the Bank’s ownership of stock in BI Investments, LLC was exchanged for Infinex stock as part of a merger.

The revenues of the Bank are primarily derived from interest on, and fees received in connection with, real estate and other loans, and from interest and dividends from investment and mortgage-backed securities, and short-term

investments. The principal sources of funds for the Bank's lending activities are its deposits, repayment of loans, the sale and maturity of investment securities, and borrowings from the Federal Home Loan Bank ("FHLB") of Atlanta. Additional revenues are derived from fees for deposit-related and WMS-related services. The Bank's principal expenses are the interest paid on deposits and operating and general administrative expenses.

As is the case with banking institutions generally, the Bank's operations are materially and significantly influenced by general economic conditions and by related monetary and fiscal policies of financial institution regulatory agencies, including the Board of Governors of the Federal Reserve System ("Federal Reserve"). As a Virginia-chartered bank and a member of the Federal Reserve, the Bank is supervised and examined by the Federal Reserve and the Virginia State Corporation Commission ("SCC"). 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. See "Competition" below.

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As of December 31, 2010, the Company had total consolidated assets of \$598.0 million, total loans net of allowance for loan losses of \$460.4 million, total consolidated deposits of \$520.1 million, and total consolidated shareholders' equity of \$44.1 million.

### LENDING ACTIVITIES

The Bank offers a range of lending services, including real estate, consumer and commercial loans, to individuals as well as small-to-medium sized businesses and other organizations that are located in or conduct a substantial portion of their business in the Bank's market area. The Bank's total loans, net of allowance, at December 31, 2010 were \$460.4 million, or 77.0% of total assets. The interest rates charged on loans vary with the degree of risk, maturity, and amount of the loan, and are further subject to competitive pressures, money market rates, availability of funds and government regulations. The Bank has no foreign loans, sub-prime loans or loans for highly leveraged transactions.

The Bank's general market area for lending consists of Fauquier and Prince William Counties, Virginia and the neighboring communities. There is no assurance that this area will experience economic growth. Continued adverse economic conditions in any one or more of the industries operating in Fauquier or Prince William Counties, the continued slow-down in general economic conditions, and/or declines in the market value of local commercial and/or residential real estate may continue to have an adverse effect on the Company and the Bank.

The Bank's loans are concentrated in three major areas: real estate loans, commercial loans, and consumer loans. Approximately 6.4% and 1.5% of the Bank's loan portfolio at December 31, 2010 consisted of commercial and consumer loans, respectively. The majority of the Bank's loans are made on a secured basis. As of December 31, 2010, approximately 92.1% of the loan portfolio consisted of loans secured by mortgages on real estate. Income from loans increased \$376,000 to \$26.85 million for 2010 compared with \$26.47 million for 2009 due to the increase in average loans balances. No material part of the Bank's business is dependent upon a single or a few customers, and the loss of any single customer would not have a materially adverse effect upon the Bank's business.

### LOANS SECURED BY REAL ESTATE

**ONE TO FOUR ("1-4") FAMILY RESIDENTIAL LOANS.** The Bank's 1-4 family residential mortgage loan portfolio primarily consists of conventional loans, generally with fixed interest rates with 15 or 30 year terms, and balloon loans with fixed interest rates, and 3, 5, 7, or 10-year maturities but utilizing amortization schedules of 30 years or less. As of December 31, 2010, the Bank's 1-4 family residential loans amounted to \$136.1 million, or 29.1% of the total loan portfolio. Substantially the Bank's entire single-family residential mortgage loans are secured by properties located in the Bank's service area. The Bank requires private mortgage insurance if the principal amount of the loan exceeds 80% of the value of the property held as collateral.

**HOME EQUITY LINES OF CREDIT LOANS.** The Bank's home equity line of credit loan portfolio primarily consists of conventional loans, generally with variable interest rates that are tied to the Wall Street Journal prime rate with 10 year terms. As of December 31, 2010, the Bank's home equity loans amounted to \$51.0 million, or 10.9% of the total loan portfolio. Substantially the Bank's entire home equity line of credit loan portfolio is secured by properties located in the Bank's service area. The Bank requires a maximum loan-to-value ratio of 85% of the value of the property held as collateral.

**CONSTRUCTION LOANS.** The majority of the Bank's construction loans are made to individuals to construct a primary residence. Such loans have a maximum term of twelve months, a fixed rate of interest, and loan-to-value ratios of 80% or less of the appraised value upon completion. The Bank requires that permanent financing, with the Bank or some other lender, be in place prior to closing any construction loan. Construction loans are generally considered to involve a higher degree of credit risk than single-family residential mortgage loans. The risk of loss on a

construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion. The Bank also provides construction loans and lines of credit to developers. Such loans generally have maximum loan-to-value ratios of 80% of the appraised value upon completion. The loans are made with a fixed rate of interest. The majority of construction loans are made to selected local developers for the building of single-family dwellings on either a pre-sold or speculative basis. The Bank limits the number of unsold units under construction at one time. Loan proceeds are disbursed in stages after inspections of the project indicate that such disbursements are for costs already incurred and that have added to the value of the project. Construction loans include loans to developers to acquire the necessary land, develop the site and construct the residential units. As of December 31, 2010, the Bank's construction loans totaled \$27.4 million, or 5.9% of the total loan portfolio.



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COMMERCIAL REAL ESTATE LOANS. Loans secured by commercial real estate comprised \$215.3 million, or 46.1% of total loans at December 31, 2010, and consist principally of commercial loans for which real estate constitutes a source of collateral. Approximately \$98.1 million or 45% of commercial real estate loans are owner-occupied. Approximately \$16.1 million or 7% of commercial real estate loans are tax exempt loans to local governmental entities. Commercial real estate loans generally involve a greater degree of risk than single-family residential mortgage loans because repayment of commercial real estate loans may be more vulnerable to adverse conditions in the real estate market or the economy.

## CONSUMER LOANS

The Bank's consumer loan portfolio consists primarily of loans to individuals for various consumer purposes, but includes some business purpose loans that are payable on an installment basis. The Bank offers a wide variety of consumer loans, including installment loans, credit card loans, and other secured and unsecured credit facilities. Approximately 61% of these loans, on a dollar-value basis, are for terms of seven years or less, and are secured by liens on motor vehicles of the borrowers. An additional 7% of consumer loans are secured by other personal assets of the borrower, and the remaining 32% are made on an unsecured basis. Consumer loans are made at fixed and variable rates, and are often based on up to a seven-year amortization schedule. The consumer loan portfolio was \$7.0 million or 1.5 % of total loans at December 31, 2010.

## COMMERCIAL LOANS

The Bank's commercial loans include loans to individuals and small-to-medium sized businesses located primarily in Fauquier and Prince William Counties for working capital, equipment purchases, and various other business purposes. Equipment or similar assets secure approximately 87% of the Bank's commercial loans, on a dollar-value basis, and the remaining 13% of commercial loans are on an unsecured basis. Commercial loans have variable or fixed rates of interest. Commercial lines of credit are typically granted on a one-year basis. Other commercial loans with terms or amortization schedules longer than one year will normally carry interest rates that vary with the prime lending rate and other financial indices and will be payable in full in three to five years.

Loan originations are derived from a number of sources, including existing customers and borrowers, walk-in customers, advertising, and direct solicitation by the Bank's loan officers. Certain credit risks are inherent in originating and keeping loans on the Bank's balance sheet. These include interest rate and prepayment risks, risks resulting from uncertainties in the future value of collateral, risks resulting from changes in economic and industry conditions, and risks inherent in dealing with individual borrowers. In particular, longer maturities increase the risk that economic conditions will change and adversely affect our ability to collect. The Bank attempts to minimize loan losses through various means. In particular, on larger credits, the Bank generally relies on the cash flow of a debtor as the source of repayment and secondarily on the value of the underlying collateral. In addition, the Bank attempts to utilize shorter loan terms in order to reduce the risk of a decline in the value of such collateral. The commercial loan portfolio was \$29.8 million or 6.4% of total loans at December 31, 2010.

## DEPOSIT ACTIVITIES

Deposits are the major source of the Bank's funds for lending and other investment activities. The Bank considers its regular savings, demand, negotiable order of withdrawal ("NOW"), premium NOW, money market deposit accounts, and non-brokered time deposits under \$100,000 to be core deposits. These accounts comprised approximately 73.0% of the Bank's total deposits at December 31, 2010. Generally, the Bank attempts to maintain the rates paid on its deposits at a competitive level. Time deposits of \$100,000 through \$250,000, and time deposits greater than \$250,000 made up approximately 13.6% and 5.8%, respectively of the Bank's total deposits at December 31, 2010. During 2010, time deposits of \$100,000 and over generally paid interest at rates the same or higher than certificates of less than

\$100,000. The majority of the Bank's deposits are generated from Fauquier and Prince William Counties. Included in interest-bearing deposits at December 31, 2010 were \$39.3 million of brokered deposits, or 7.6% of total deposits. Of the brokered deposits, \$28.0 million or 5.4% of total deposits represent a reciprocal arrangement for existing Bank customers who desire FDIC insurance for deposits above current limits.

## INVESTMENTS

The Bank invests a portion of its assets in U.S. Government-sponsored corporation and agency obligations, state, county and municipal obligations, corporate obligations, mutual funds, FHLB stock and equity securities. The Bank's investments are managed in relation to loan demand and deposit growth, and are generally used to provide for the investment of excess funds at reduced yields and risks relative to yields and risks of the loan portfolio, while providing liquidity to fund increases in loan demand or to offset fluctuations in deposits. The Bank's total unrestricted and restricted investments, at fair value, were \$46.5 million and \$3.4 million, respectively, or 7.8% and 0.6% of total assets, respectively, at December 31, 2010. During 2010, income from investments totaled \$546,000, consisting of \$1.41 million of interest and dividend income and \$541,000 in gains on the sale of investments, partially offset by a loss of \$1.40 million associated with recognition of other than temporary impairment on investment in pooled trust-preferred securities and government agency preferred stock.

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GOVERNMENT SUPERVISION AND REGULATION

GENERAL. Bank holding companies and banks are extensively regulated under both federal and state law. The following summary briefly addresses certain provisions of federal and state laws that apply to the Company or the Bank. This summary does not purport to be complete and is qualified in its entirety by reference to the particular statutory or regulatory provisions.

EFFECT OF GOVERNMENTAL MONETARY POLICIES. The earnings and business of the Company and the Bank are affected by the economic and monetary policies of various regulatory authorities of the United States, especially the Federal Reserve. The Federal Reserve, among other things, regulates the supply of credit and money and setting interest rates in order to influence general economic conditions within the United States. The instruments of monetary policy employed by the Federal Reserve for those purposes influence in various ways the overall level of investments, loans, other extensions of credits, and deposits, and the interest rates paid on liabilities and received on assets. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

THE DODD-FRANK ACT. On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The Dodd-Frank Act will have a significant impact on financial institutions, with increased regulatory and compliance changes. A summary of certain provisions of the Dodd-Frank Act is set forth below:

Increased Capital Standards. The federal banking agencies are required to establish minimum leverage and risk-based capital requirements for banks and bank holding companies. These new standards will be no lower than current regulatory capital and leverage standards applicable to insured depository institutions and may, in fact, be higher when established by the agencies.

Deposit Insurance. The Dodd-Frank Act makes permanent the \$250,000 deposit insurance limit for insured deposits. Amendments to the Federal Deposit Insurance Act also revise the assessment base against which an insured depository institution’s deposit insurance premiums paid to the Deposit Insurance Fund (“DIF”) will be calculated. Under the amendments, the assessment base will no longer be the institution’s deposit base, but rather its average consolidated total assets less its average tangible equity during the assessment period. Additionally, the Dodd-Frank Act makes changes to the minimum designated reserve ratio of the DIF, increasing the minimum from 1.15% to 1.35% of the estimated amount of total insured deposits and eliminating the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds. In December 2010, the FDIC increased the reserve ratio to 2.0%. The Dodd-Frank Act also provides that, effective one year after the date of enactment, depository institutions may pay interest on demand deposits.

Enhanced Lending Limits. The Dodd-Frank Act strengthens the existing limits on a depository institution’s credit exposure to one borrower. Current banking law limits a depository institution’s ability to extend credit to one person (or group of related persons) in an amount exceeding certain thresholds. The Dodd-Frank Act expands the scope of these restrictions to include credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.

The Consumer Financial Protection Bureau (“Bureau”). The Dodd-Frank Act creates the Bureau within the Federal Reserve. The Bureau will establish rules and regulations under certain federal consumer protection laws with respect to the conduct of providers of certain consumer financial products and services. In addition, the Dodd-Frank Act permits states to adopt consumer protection laws and regulations that are more stringent than those regulations promulgated by the Bureau and state attorneys general are permitted to enforce consumer protection rules adopted by the Bureau against state-chartered institutions.

Compensation Practices. The Dodd-Frank Act provides that the appropriate federal regulators must establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company or other “covered financial institution” that provides an insider or other employee with “excessive compensation” or could lead to a material financial loss to such firm. In June 2010, prior to the Dodd-Frank Act, the bank regulatory agencies promulgated the Interagency Guidance on Sound Incentive Compensation Policies, which requires that financial institutions establish metrics for measuring the impact of activities to achieve incentive compensation with the related risk to the financial institution of such behavior.

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The requirements of the Dodd-Frank Act will significantly affect banks and other financial institutions. However, because much of these requirements will be phased in over time and will not become effective until federal agency rulemaking initiatives are completed, the Company cannot fully assess the impact of Dodd-Frank Act on the Company and the Bank. The Company does believe, however, that short- and long-term compliance costs for the Company will be greater because of the Dodd-Frank Act.

**EMERGENCY ECONOMIC STABILIZATION ACT OF 2008.** Deteriorating market conditions in 2008 led to the enactment of the Emergency Economic Stabilization Act of 2008 (the “EESA”) on October 3, 2008. The EESA authorized the Troubled Asset Relief Plan (“TARP”) with an objective to ease the downturn in the credit cycle. The TARP provided up to \$700 billion to the U.S. Department of the Treasury (the “Treasury”) to buy mortgages and other troubled assets, to provide guarantees and to inject capital into financial institutions. As part of the \$700 billion TARP, the Treasury established a Capital Purchase Program (“CPP”), which allows the Treasury to purchase up to \$250 billion of senior preferred shares issued by U.S. financial institutions. The EESA also temporarily raised the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor (which has since been made permanent.)The Company, after considerable analysis and deliberation, chose not to participate in the CPP.

**SARBANES-OXLEY ACT OF 2002.** The Company is subject to the periodic reporting requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), including the filing of annual, quarterly, and other reports with the Securities and Exchange Commission (the “SEC”). As an Exchange Act reporting company, the Company is directly affected by the Sarbanes-Oxley Act of 2002 (the “SOX”), which is aimed at improving corporate governance, internal controls and reporting procedures. The Company is complying with applicable SEC and other rules and regulations implemented pursuant to the SOX and intends to comply with any applicable rules and regulations implemented in the future.

**FINANCIAL SERVICES MODERNIZATION LEGISLATION.** The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (the “GLB Act”) was intended to modernize the financial services industry by establishing a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers under a “financial holding company” structure. Under the GLB Act, bank holding companies that are well-capitalized and well-managed and meet other conditions can elect to become “financial holding companies.” As financial holding companies, they and their subsidiaries are permitted to acquire or engage in previously impermissible activities such as insurance underwriting, securities underwriting and distribution, travel agency activities, insurance agency activities, merchant banking and other activities that the Federal Reserve determines to be financial in nature or complementary to these activities. Financial holding companies continue to be subject to the overall oversight and supervision of the Federal Reserve, but the GLB Act applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. Although the Company could qualify to become a financial holding company under the GLB Act, it does not contemplate seeking to do so unless it identifies significant specific benefits from doing so. The GLB Act has not had a material effect on the Company operations.

**BANK HOLDING COMPANY REGULATION.** The Company is a one-bank holding company, registered with the Federal Reserve under the Bank Holding Company Act of 1956 (the “BHC Act”). As such, the Company is subject to the supervision, examination, and reporting requirements of the BHC Act and the regulations of the Federal Reserve. The Company is required to furnish to the Federal Reserve an annual report of its operations at the end of each fiscal year and such additional information as the Federal Reserve may require pursuant to the BHC Act. The BHC Act generally prohibits the Company from engaging in activities other than banking or managing or controlling banks or other permissible subsidiaries and from acquiring or retaining direct or indirect control of any company engaged in any activities other than those activities determined by the Federal Reserve to be sufficiently related to banking or managing or controlling banks. With some limited exceptions, the BHC Act requires every bank holding company to obtain the prior approval of the Federal Reserve before: acquiring substantially all the assets of any bank; acquiring

direct or indirect ownership or control of any voting shares of any bank if after such acquisition it would own or control more than 5% of the voting shares of such bank (unless it already owns or controls the majority of such shares); or merging or consolidating with another bank holding company. In addition, and subject to some exceptions, the BHC Act and the Change in Bank Control Act, together with the regulations promulgated thereunder, require Federal Reserve approval prior to any person or company acquiring “control” of a bank holding company.

**BANK REGULATION.** The Bank is chartered under the laws of the Commonwealth of Virginia. The FDIC insures its deposits to the maximum extent provided by law. The Bank is subject to comprehensive regulation, examination and supervision by the Federal Reserve and to other laws and regulations applicable to banks. These regulations include limitations on loans to a single borrower and to the Bank’s directors, officers and employees; restrictions on the opening and closing of branch offices; requirements regarding the maintenance of prescribed capital and liquidity ratios; requirements to grant credit under equal and fair conditions; and requirements to disclose the costs and terms of such credit. State regulatory authorities also have broad enforcement powers over the Bank, including the power to impose fines and other civil or criminal penalties and to appoint a receiver in order to conserve the Bank’s assets for the benefit of depositors and other creditors.

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The Bank is also subject to the provisions of the Community Reinvestment Act of 1977 (“CRA”). Under the terms of the CRA, the appropriate federal bank regulatory agency is required, in connection with its examination of a bank, to assess the bank’s record in meeting the credit needs of the community served by that bank, including low-and moderate-income neighborhoods. The regulatory agency’s assessment of a bank’s record is made available to the public. Such assessment is required of any bank that has applied to (i) charter a national bank, (ii) obtain deposit insurance coverage for a newly chartered institution, (iii) establish a new branch office that will accept deposits, (iv) relocate an office, or (v) merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. In the case of a bank holding company applying for approval to acquire a bank or other bank holding company, the Federal Reserve will assess the record of each subsidiary bank of the applicant bank holding company, and such records may be the basis for denying the application. The Bank received a rating of “satisfactory” at its last CRA performance evaluation as of March 1, 2010.

**DIVIDENDS.** Dividends from the Bank constitute the primary source of funds for dividends to be paid by the Company. There are various statutory and contractual limitations on the ability of the Bank to pay dividends, extend credit, or otherwise supply funds to the Company, including the requirement under Virginia banking laws that cash dividends only be paid out of net undivided profits and only if such dividends would not impair the capital of the Bank. The Federal Reserve also has the general authority to limit the dividends paid by bank holding companies and state member banks, if the payment of dividends is deemed to constitute an unsafe and unsound practice. The Federal Reserve has indicated that banking organizations should generally pay dividends only if (1) the organization’s net income available to common shareholders over the past year has been sufficient to fund fully the dividends and (2) the prospective rate of earnings retention appears consistent with the organization’s capital needs, asset quality and overall financial condition. The Bank does not expect any of these laws, regulations or policies to materially impact its ability to pay dividends to the Company.

**INSURANCE OF DEPOSITS.** The Bank’s deposit accounts are insured by the FDIC up to applicable maximum limits. The FDIC issues regulations, conducts periodic examinations, requires the filing of reports and generally supervises the operations of its insured banks. Any insured bank that is not operated in accordance with or does not conform to FDIC regulations, policies and directives may be sanctioned for non-compliance. Proceedings may be instituted against any insured bank or any director, officer, or employee of an insured bank engaging in unsafe and unsound practices, including the violation of applicable laws and regulations. The FDIC has the authority to terminate insurance of accounts pursuant to procedures established for that purpose.

Under current regulations, FDIC-insured depository institutions pay insurance premiums at rates based on their assessment risk classification, which is determined, in part, based on the institution’s capital ratios and on factors that the FDIC deems relevant to determine the risk of loss to the FDIC. In 2007, the annual assessment rates changed to a range of 5-43 basis points, an increase from the 0-27 basis point range that had been in effect since 1996. In 2009, the base assessment rate range for Risk Category 1 institutions increased to 7-24 basis points as part of the FDIC’s Restoration Plan for the Deposit Insurance Fund (“DIF”). This increase was necessary to replenish the DIF due to the number of recent failures of FDIC-insured institutions. The amount an institution is assessed is based upon statutory factors that include the balance of insured deposits as well as the degree of risk the institution poses to the DIF and may be reviewed semi-annually.

On May 22, 2009, the FDIC voted to levy a special assessment on insured institutions as part of the FDIC’s efforts to rebuild the DIF and help maintain public confidence in the banking system. The special assessment was 5 basis points on each FDIC-insured depository institution’s assets, minus its Tier 1 capital, as of June 30, 2009. On September 30, 2009, the Company paid a special assessment of \$241,315. On November 12, 2009, the FDIC voted to require insured institutions to prepay slightly over three years of estimated insurance assessments. The pre-payment allows the FDIC to strengthen the cash position of the DIF immediately without immediately impacting earnings of the industry. During the fourth quarter of 2009, the Company pre-paid estimated assessments of \$2,430,625 for 13

quarters starting in the fourth quarter of 2009 through fourth quarter of 2012.

The Dodd-Frank Act set a new minimum DIF reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. In addition, the Dodd-Frank Act will have a significant impact on the calculation of deposit insurance assessment premiums going forward. Specifically, the Dodd-Frank Act generally requires the FDIC to define the deposit insurance assessment base for an insured depository institution as an amount equal to the institution's average consolidated total assets during the assessment period minus average tangible equity. The FDIC issued a final rule that implements this change to the assessment calculation on February 7, 2011, but has said that the new assessment rate schedule should result in the collection of assessment revenue that is approximately revenue neutral even though the new assessment base under the Dodd-Frank Act is larger than the current assessment base. The rule retains the risk category system for small insured depository institutions (i.e., with less than \$10 billion in assets), assigning each institution to one of four risk categories based upon the institution's capital evaluation and supervisory evaluation, as defined by the rule. The total base assessment rates for Risk Category 1 institutions range from 2.5 to 9 basis points, on an annualized basis. This rule will take effect for the quarter beginning April 1, 2011, and will be reflected in the June 30, 2011 fund balance and the invoices for assessments due September 30, 2011. Premiums for the Bank will be calculated based upon the average balance of total assets minus average tangible equity as of the close of business for each day during the calendar quarter. The FDIC rule also provides the FDIC with the flexibility to adopt actual rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.



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**CAPITAL REQUIREMENTS.** The federal bank regulatory authorities have adopted risk-based capital guidelines for banks and bank holding companies that are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks and bank holding companies. The resulting capital ratios represent qualifying capital as a percentage of total risk-weighted assets and off-balance sheet items. The guidelines establish minimums, and the federal regulators have noted that banks and bank holding companies contemplating significant expansion programs should maintain all ratios well in excess of the minimums and should not allow expansion to diminish their capital ratios. The current guidelines require all bank holding companies and federally regulated banks to maintain a minimum risk-based total capital ratio equal to 8%, of which at least 4% must be Tier 1 capital. Tier 1 capital includes common stockholders' equity, retained earnings, qualifying perpetual preferred stock, and certain hybrid capital instruments, but excludes goodwill and most other intangibles and excludes the allowance for loan and lease losses. Tier 2 capital includes the excess of any preferred stock not included in Tier 1 capital, mandatory convertible securities, certain hybrid capital instruments, subordinated debt and intermediate term-preferred stock, and general reserves for loan and lease losses up to 1.25% of risk-weighted assets. As of December 31, 2010, the Bank had a total risk-based capital ratio of 12.36% and a Tier 1 risk-based capital ratio of 11.11%, and the Company had a total risk-based capital ratio of 12.55% and a Tier 1 risk-based capital ratio of 11.30%.

Each of the federal regulatory agencies has also established leverage capital ratio guidelines for banking organizations (Tier 1 capital to average tangible assets, or the "leverage ratio"). These guidelines generally provide for a minimum leverage ratio of 4.0% for banks and bank holding companies (3% for institutions receiving the highest rating on the CAMELS financial institution rating system.) As of December 31, 2010, the Bank had a leverage ratio of 8.10%, and the Company had a leverage ratio of 8.55%.

**THE FDIC IMPROVEMENT ACT OF 1991 ("FDICIA").** The FDIC Improvement Act of 1991 made a number of reforms addressing the safety and soundness of deposit insurance funds, supervision, accounting, and prompt regulatory action with respect to insured institutions such as the Bank which have total assets of \$250 million or more. Annual full-scope, on-site regulatory examinations are required of all insured depository institutions. The cost for conducting an examination of an institution may be assessed to the institution, with special consideration given to affiliates and any penalties imposed for failure to provide information requested. Insured state banks also are precluded from engaging as principal in any type of activity that is impermissible for a national bank, including activities relating to insurance and equity investments. FDICIA also re-codified current law under the Federal Reserve Act restricting extensions of credit to insiders.

FDICIA also contains "prompt corrective action" provisions pursuant to which banks are classified into one of five categories based upon capital adequacy, ranging from "well capitalized" to "critically undercapitalized" and which require (subject to certain exceptions) the appropriate federal banking agency to take prompt corrective action with respect to an institution which becomes "significantly undercapitalized" or "critically undercapitalized".

The FDIC has issued regulations to implement the "prompt corrective action" provisions of FDICIA. In general, the regulations define the five capital categories as follows: (i) an institution is "well capitalized" if it has a total risk-based capital ratio of 10% or greater, has a Tier 1 risk-based capital ratio of 6% or greater, has a leverage ratio of 5% or greater and is not subject to any written order or directive to meet and maintain a specific capital level for any capital measure; (ii) an institution is "adequately capitalized" if it has a total risk-based capital ratio of 8% or greater, has a Tier 1 risk-based capital ratio of 4% or greater, and has a leverage ratio of 4% or greater; (iii) an institution is "undercapitalized" if it has a total risk-based capital ratio of less than 8%, has a Tier 1 risk-based capital ratio that is less than 4% or has a leverage ratio that is less than 4%; (iv) an institution is "significantly undercapitalized" if it has a total risk-based capital ratio that is less than 6%, a Tier 1 risk-based capital ratio that is less than 3% or has a leverage ratio that is less than 3%; and (v) an institution is "critically undercapitalized" if its "tangible equity" is equal to or less than 2% of its total assets. The FDIC may take various corrective actions against any undercapitalized bank and any bank that fails to submit an acceptable capital restoration plan or fails to implement a plan accepted by the FDIC. These powers

include, but are not limited to, requiring the institution to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions by any bank holding company that controls the institution, requiring divestiture by the institution of its subsidiaries or by the holding company of the institution itself, requiring new election of directors, and requiring the dismissal of directors and officers. The Bank was notified by the Federal Reserve Bank of Richmond that, at December 31, 2010, both the Company and the Bank were considered “well capitalized.”

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FEDERAL HOME LOAN BANK OF ATLANTA. The Bank is a member of the FHLB of Atlanta, which is one of twelve regional FHLBs that provide funding to their members for making housing loans as well as loans for affordable housing and community development lending. Each FHLB serves as a reserve or central bank for its members within its assigned region. It is funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB system. It makes loans to its members (i.e., advances) in accordance with policies and procedures established by the Board of Directors of the FHLB. As a member, the Bank is required to purchase and maintain stock in the FHLB in an amount equal to at least 5% of the aggregate outstanding advances made by the FHLB to the Bank. In addition, the Bank is required to pledge collateral for outstanding advances. The borrowing agreement with the FHLB of Atlanta provides for the pledge by the Bank of various forms of securities and mortgage loans as collateral.

USA PATRIOT ACT. The USA PATRIOT Act became effective on October 26, 2001 and provides for the facilitation of information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering. Among other provisions, the USA PATRIOT Act permits financial institutions, upon providing notice to the United States Treasury, to share information with one another in order to better identify and report to the federal government concerning activities that may involve money laundering or terrorists' activities. The USA PATRIOT Act is considered a significant banking law in terms of information disclosure regarding certain customer transactions. Certain provisions of the USA PATRIOT Act impose the obligation to establish anti-money laundering programs, including the development of a customer identification program, and the screening of all customers against any government lists of known or suspected terrorists. Although it does create a reporting obligation and a cost of compliance, the USA PATRIOT Act has not materially affected the Bank's products, services, or other business activities.

MORTGAGE BANKING REGULATION. The Bank's mortgage banking activities are subject to the rules and regulations of, and examination by the Department of Housing and Urban Development, the Federal Housing Administration, the Department of Veterans Affairs and state regulatory authorities with respect to originating, processing and selling mortgage loans. Those rules and regulations, among other things, establish standards for loan origination, prohibit discrimination, provide for inspections and appraisals of property, require credit reports on prospective borrowers and, in some cases, restrict certain loan features, and fix maximum interest rates and fees. In addition to other federal laws, mortgage origination activities are subject to the Equal Credit Opportunity Act, Truth-in-Lending Act, Home Mortgage Disclosure Act, Real Estate Settlement Procedures Act, and Home Ownership Equity Protection Act, and the regulations promulgated under these acts. These laws prohibit discrimination, require the disclosure of certain basic information to mortgagors concerning credit and settlement costs, limit payment for settlement services to the reasonable value of the services rendered and require the maintenance and disclosure of information regarding the disposition of mortgage applications based on race, gender, geographical distribution and income level.

CONSUMER LAWS AND REGULATIONS. The Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth-in-Lending Act, the Truth-in-Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, and the Fair Housing Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans to or engaging in other types of transactions with such customers.

## LOANS TO INSIDERS

The Federal Reserve Act and related regulations impose specific restrictions on loans to directors, executive officers and principal shareholders of banks. Under Section 22(h) of the Federal Reserve Act, loans to a director, an executive

officer and to a principal shareholder of a bank, and some affiliated entities of any of the foregoing, may not exceed, together with all other outstanding loans to such person and affiliated entities, the bank's loan-to-one borrower limit. Loans in the aggregate to insiders and their related interests as a class may not exceed two times the bank's unimpaired capital and unimpaired surplus until the bank's total assets equal or exceed \$100 million, at which time the aggregate is limited to the bank's unimpaired capital and unimpaired surplus. Section 22(h) also prohibits loans, above amounts prescribed by the appropriate federal banking agency, to directors, executive officers and principal shareholders of a bank or bank holding company, and their respective affiliates, unless such loan is approved in advance by a majority of the board of directors of the bank with any "interested" director not participating in the voting. The FDIC has prescribed the loan amount, which includes all other outstanding loans to such person, as to which such prior board of director approval is required, as being the greater of \$25,000 or 5% of capital and surplus (up to \$500,000). Section 22(h) requires that loans to directors, executive officers and principal shareholders be made on terms and underwriting standards substantially the same as offered in comparable transactions to other persons.

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### FUTURE REGULATORY UNCERTAINTY

Because federal regulation of financial institutions changes regularly and is the subject of constant legislative debate, the Company cannot forecast how federal regulation of financial institutions may change in the future and impact its operations. Although Congress in recent years has sought to reduce the regulatory burden on financial institutions with respect to the approval of specific transactions, the Company fully expects that the financial institution industry will remain heavily regulated in the near future and that additional laws or regulations may be adopted further regulating specific banking practices.

### COMPETITION

The Company encounters strong competition both in making loans and in attracting deposits. In one or more aspects of its business, the Bank competes with other commercial banks, savings and loan associations, credit unions, finance companies, mutual funds, insurance companies, brokerage and investment banking companies, and other financial intermediaries. Most of these competitors, some of which are affiliated with bank holding companies, have substantially greater resources and lending limits, and may offer certain services that the Bank does not currently provide. In addition, many of the Bank's non-bank competitors are not subject to the same level of federal regulation that governs bank holding companies and federally insured banks. Recent federal and state legislation has heightened the competitive environment in which financial institutions must conduct their business, and the potential for competition among financial institutions of all types has increased significantly. To compete, the Bank relies upon specialized services, responsive handling of customer needs, and personal contacts by its officers, directors, and staff. Large multi-branch banking institutions tend to compete based primarily on price and the number and location of branches while smaller, independent financial institutions tend to compete primarily on price and personal service.

### EMPLOYEES

As of December 31, 2010, the Company and the Bank employed 144 full-time employees and 31 part-time employees compared with 137 full-time and 28 part-time employees as of December 31, 2009. The increase in employees from 2009 to 2010 is primarily due to the opening of the Haymarket branch office in January 2010. No employee is represented by a collective bargaining unit. The Company and the Bank consider relations with employees to be good.

### AVAILABLE INFORMATION

The Company files annual, quarterly and current reports, proxy statements and other information with the SEC. The Company's SEC filings are filed electronically and are available to the public over the internet at the SEC's website at <http://www.sec.gov>. In addition, any document filed by the Company with the SEC can be read and copied at the SEC's public reference facilities at 100 F Street, N.E., Washington, D.C. 20549. Copies of documents can be obtained at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the public reference room by calling 1-800-SEC-0330. The Company's website is <http://www.fauquierbank.com>. The Company makes its SEC filings available through this website under "Investor Relations," "Documents" as soon as practicable after filing or furnishing the material to the SEC. Copies of documents can also be obtained free of charge by writing to Secretary, Fauquier Bankshares, Inc. at 10 Courthouse Square, Warrenton, Virginia 20186 or by calling 540-347-2700.

### ITEM 1A.

### RISK FACTORS

The information on the Company's website is not, and shall not be deemed to be, a part of this Annual Report on Form 10-K or incorporated into any other filings the Company makes with the SEC.



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The Company may continue to be adversely affected by economic conditions in our market area, as well as national and international economic conditions.

The Company's marketplace is primarily in Fauquier and western Prince William Counties, Virginia and the neighboring communities. Many, if not most, of the Company's customers live and/or work in the greater Washington, D.C. metropolitan area. Because the Company's lending, deposit gathering, and wealth management services are concentrated in this market, the Company is affected by the general economic conditions in the greater Washington area. Changes in the economy may influence the growth rate of the Company's loans and deposits, the quality of the loan portfolio and loan and deposit pricing and the performance of the Company's wealth management business. A significant decline in economic conditions caused by inflation, recession, unemployment or other factors beyond the Company's control could decrease the demand for banking products and services generally, and could continue to impair the ability of existing borrowers to repay their loans, which could continue to negatively affect the Company's financial condition and performance.

Within the Bank's investment portfolio are municipal bonds issued by state and/or local governments outside of the Bank's own market area. At December 31, 2010, the Bank had \$5.6 million in municipal bonds, at fair value, all from geographic areas outside of the Bank's market area. Also within the Bank's investment portfolio are \$552,000 of corporate bonds, at fair value, that are "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 50 different financial institutions, which, for the most part, are outside the Bank's market area. All \$552,000 of these corporate bonds are considered impaired at this time due to the current uncertainty of interest and principal payments from the different financial institutions.

The Company has a high concentration of loans secured by both residential and commercial real estate and a downturn in either or both real estate markets, for any reason, may continue to increase the Company's credit losses, which would negatively affect its financial results.

The Company offers a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity, consumer and other loans. Most of the Company's loans are secured by real estate (both residential and commercial) in its market area. At December 31, 2010, approximately 40.0% and 46.1% of the Company's \$466.7 million loan portfolio were secured by post-construction residential and commercial real estate including farmland, respectively, with construction loans representing an additional 5.9% of its loans secured by real estate. Changes in the real estate market, such as the greater deterioration in market value of collateral, or a greater decline in local employment, could adversely affect the Company's customers ability to pay these loans, which in turn could impact the Company's profitability. There has been a slowdown in the housing market across our geographical footprint, reflecting declining prices and excess inventories of houses to be sold. Repayment of our commercial loans is often dependent on the cash flow of the borrower, which may become unpredictable in the current economy. If the value of real estate serving as collateral for the loan portfolio were to continue to decline materially, a significant part of the loan portfolio could become under-collateralized. If the loans that are secured by real estate become troubled when real estate market conditions are declining or have declined, in the event of foreclosure, the Company may not be able to realize the amount of collateral that was anticipated at the time of originating the loan. In that event, the Company might have to increase the provision for loan losses, which could have a material adverse effect on its operating results and financial condition.

If the Company's allowance for loan losses becomes inadequate, its results of operations may be adversely affected.

The Company maintains an allowance for loan losses that it believes is a reasonable estimate of known and inherent losses in the Company's loan portfolio. Through periodic review of the Company's loan portfolio, it determines the amount of the allowance for loan losses by considering general market conditions, credit quality of the loan portfolio,

the collateral supporting the loans and performance of the Company's customers relative to their financial obligations with us. The amount of future losses is susceptible to changes in economic and other market conditions, including changes in interest rates and collateral values that are beyond the Company's control, and these future losses may exceed current estimates. Rapidly growing loan portfolios are, by their nature, unseasoned. As a result, estimating loan loss allowances is more difficult, and may be more susceptible to changes in estimates, and to losses exceeding estimates, than more seasoned portfolios. Although the Company believes the allowance for loan losses is a reasonable estimate of known and inherent losses in its loan portfolio, it cannot fully predict such losses or that the loan loss allowance will be adequate in the future. Excessive loan losses could have a material impact on its financial performance.



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Federal and state regulators periodically review the Company's allowance for loan losses and may require us to increase the provision for loan losses or recognize further loan charge-offs, based on judgments different than those of management. Any increase in the amount of the Company's provision or loans charged-off as required by these regulatory agencies could have a negative effect on its operating results.

The Company may incur losses if it is unable to successfully manage interest rate risk.

The Company's profitability depends in substantial part upon the spread between the interest rates earned on investments and loans and interest rates paid on deposits and other interest-bearing liabilities. The Company may selectively pay above-market rates to attract deposits as it has done in some of the Company's marketing promotions in the past. Changes in interest rates will affect the Company's operating performance and financial condition in diverse ways including the pricing of securities, loans and deposits, which, in turn, may affect the growth in loan and retail deposit volume. The Company attempts to minimize the Company's exposure to interest rate risk, but cannot eliminate it. The Company's net interest income will be adversely affected if market interest rates change so that the interest it pays on deposits and borrowings increases faster than the interest earned on loans and investments. Changes in interest rates also affect the value of the Company's loans. An increase in interest rates could adversely affect the Company's borrowers' ability to pay the principal or interest on existing loans or reduce their desire to borrow more money. This may lead to an increase in nonperforming assets or a decrease in loan originations, either of which could have a material and negative effect on the Company's results of operations. The Company's net interest spread will depend on many factors that are partly or entirely outside its control, including competition, federal economic, monetary and fiscal policies, and economic conditions generally. Fluctuations in market rates are neither predictable nor controllable and may have a material and negative effect on the Company's business, financial condition and results of operations.

The Company's profitability may suffer because of rapid and unpredictable changes in the highly regulated environment in which the Company operates.

The Company is subject to extensive supervision by several governmental regulatory agencies at the federal and state levels. Recently enacted, proposed and future banking legislation and regulations have had, will continue to have, or may have a significant impact on the financial services industry. These regulations, which are intended to protect depositors and/or borrowers, and the interpretation and application of them by federal and state regulators, are beyond the Company's control, and may change rapidly and unpredictably and can be expected to influence its earnings and growth. The Company's success depends on its continued ability to maintain compliance with these regulations. Failure to comply with existing or new laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have an adverse effect on the Company's business, financial condition and results of operations. Regulatory changes may increase costs, limit the types of financial services and products offered and/or increase the ability of non-banks to offer competing financial services and products and thus place other entities that are not subject to similar regulation in stronger, more favorable competitive positions, which could adversely affect the Company's growth.

Increases in FDIC insurance premiums may adversely affect our earnings.

During 2008, 2009 and 2010, higher levels of bank failures have dramatically increased resolution expenses and depleted the fund resources of the FDIC. As result, the FDIC has increased assessment rates and periodically imposed special assessments. We may be required to pay even higher premiums than the recently increased levels.

The Company depends on the services of its key personnel, and a loss of any of those personnel would disrupt operations and result in reduced revenues.

The Company's success depends upon the continued service of the senior management team and upon their ability to attract and retain qualified financial services personnel. Competition for qualified employees is intense. In the Company's experience, it can take a significant period of time to identify and hire personnel with the combination of skills and attributes required in carrying out its strategy. If the Company loses the services of key personnel, or are unable to attract additional qualified personnel, its business, financial condition, results of operations and cash flows could be materially adversely affected.

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The Company's future success is dependent on its ability to compete effectively in the highly competitive financial services industry.

The Northern Virginia and the greater Washington, D.C. metropolitan area in which the Company operates is considered highly attractive from an economic and demographic viewpoint, and is therefore a highly competitive banking and mortgage banking market. The Company faces vigorous competition from other banks and other financial service institutions in the Company's market area. A number of these banks and other financial institutions are significantly larger and have substantially greater access to capital and other resources, larger lending limits, wider branch networks, and larger marketing budgets. To a limited extent, the Company also competes with other providers of financial services, such as money market mutual funds, brokerage firms, consumer finance companies, insurance companies and governmental organizations which may offer more favorable financing than it can. Many of the Company's non-bank competitors are not subject to the same extensive regulations and/or tax laws that govern us. As a result, these non-bank competitors have advantages over us in providing certain services. Failure to compete effectively to attract new customers and/or retain existing customers may reduce or limit the Company's margins and market share and may adversely affect its results of operations and financial condition.

If the Company needs additional capital in the future to continue its growth, it may not be able to obtain it on terms that are favorable. Cash dividends paid on common stock may continue to be reduced or eliminated for the purpose of internally generating additional capital. This could negatively affect the value of the Company's common stock.

The Company's business strategy calls for continued growth. The Company anticipates that it will be able to support the Company's growth strategy primarily through the generation of retained earnings. However, it may need to raise additional capital in the future to support the Company's growth and to maintain capital levels. The capital and credit markets have experienced unprecedented levels of volatility and disruption over the last two years. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers underlying financial strength. The Company's ability to raise capital through the sale of additional securities will depend primarily upon its financial condition and the condition of financial markets at that time, and may not be able to obtain additional capital when needed on terms that are satisfactory to us. The Company may reduce or eliminate its cash dividend payments on common stock in order to increase capital. The Company's growth may be constrained if it is unable to raise additional capital as needed. These constraints could negatively affect the Company's performance and/or the value of common stock.

The Company is subject to a variety of operational risks, including reputational risk, legal risk, business continuity risk, compliance risk, the risk of both internal and external fraud and/or theft, all of which may adversely affect our business and the results of operations.

In addition to the monetary losses, the Company may lose the confidence of its customers as result of these operational risks.

The Company may be adversely affected if it is unable to successfully implement the Company's branch network expansion.

The Company anticipates that it will need to expand its branch network to support its growth strategy. However, the timing and cost of entry into new branch locations is substantial, and the economic payback on new branches may be impeded and delayed, which could negatively constrain the Company's growth, and adversely affect its performance and the value of common stock.

The Bank's ability to pay dividends is subject to regulatory limitations which may affect the Company's ability to pay its obligations and pay dividends.

The Company is a separate legal entity from the Bank and its subsidiaries and does not have significant operations which generate cash. It currently depends on the Bank's cash and liquidity, transferred to the Company as dividends from the Bank, to pay the Company's operating expenses and dividends to shareholders. No assurance can be made that in the future the Bank will have the capacity to pay the necessary dividends or that the Company will not require dividends from the Bank to satisfy the Company's obligations. The availability of dividends from the Bank is limited by various statutes and regulations. It is possible, depending upon the financial condition of the Company and other factors, that the state and/or federal bank regulators could assert that payment of dividends or other payments by the Bank are an unsafe or unsound practice. In the event the Bank is unable to pay sufficient dividends to the Company, the Company may not be able to service its obligations as they become due, or pay dividends on the Company's common stock. Consequently, the inability to receive dividends from the Bank could adversely affect the Company's financial condition, results of operations, cash flows and prospects.

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The Company's recent operating results may not be indicative of future operating results.

The Company's historical results of operations are not necessarily indicative of future operations.

If the Company cannot maintain its corporate culture as it grows, its business could be harmed.

The Company believes that a critical contributor to its success has been its corporate culture, which focuses on building personal relationships with its customers. As the Company's organization grows, and management is required to implement more complex organizational management structures, it may find it increasingly difficult to maintain the beneficial aspects of the Company's corporate culture. This could negatively impact future success.

Changes in accounting standards may affect the Company's performance.

The Company's accounting policies and methods are fundamental to how it records and reports its financial condition and results of operations. From time to time there are changes in the financial accounting and reporting standards that govern the preparation of the Company's financial statements. These changes can be difficult to predict and can materially impact how it records and reports the Company's financial condition and statements of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in restating prior period financial statements.

The Company's disclosure controls and procedures may not prevent or detect all errors or acts of fraud.

The Company's disclosure controls and procedures are designed to reasonably assure that information required to be disclosed by the Company in reports it files or submits under the Exchange Act is accumulated and communicated to management, and recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Company believes that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or omission. Additionally, controls can be circumvented by individual acts, by collusion by two or more people and/or by override of the established controls. Accordingly, because of the inherent limitations in the Company's control systems and in human nature, misstatements due to error or fraud may occur and not be detected.

The Company's information systems may experience an interruption or breach in security.

The Company relies heavily on communications and information systems to conduct the Company's business. Any failure, interruption or breach of security of these systems could result in failures or disruptions in the Company's customer relationship management, transaction processing systems and various accounting and data management systems. While it has policies and procedures designed to prevent and/or limit the effect of the failure, interruption or security breach of the Company's communication and information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur, or, if they do occur, they will be adequately addressed on a timely basis. The occurrence of failures, interruptions or security breaches of the Company's communication and information systems could damage the Company's reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on its financial condition and results of operations.

ITEM 1B.UNRESOLVED STAFF COMMENTS

None.



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## ITEM 2.

## PROPERTIES

The Bank owns or leases property and operates branches at the following locations:

| LOCATION   | LEASE/OWN | RENT (ANNUAL)   | EXPIRATION | RENEWAL   |
|--|-----------|---|------------|---|
| Main Office *<br>P.O. Box 561<br>10 Courthouse Square<br>Warrenton, VA 20186 | Own       | N/A   | N/A        | N/A   |
| Catlett Office<br>Rt. 28 and 806<br>Catlett, VA 20119                        | Own       | N/A   | N/A        | N/A   |
| Sudley Road Office<br>8091 Sudley Rd<br>Manassas, VA 20109                   | Lease     | \$200,000 for 2011;<br>to 2014; \$230,000<br>for 2015 to 2019;<br>\$264,500 for 2020;<br>to 2024; \$304,175<br>for 2025 to 2029 | 2029       | None  |
| Old Town Office<br>Center Street<br>Manassas, VA 20110                       | Lease     | \$44,215  | 2016       | One additional<br>option for 5 years              |
| New Baltimore Office<br>5119 Lee Highway<br>Warrenton, VA 20187              | Own       | N/A   | N/A        | N/A   |
| The Plains Office<br>6464 Main Street<br>The Plains, VA 20198                | Own       | N/A   | N/A        | N/A   |
| View Tree Property<br>87 Lee Highway<br>Warrenton, VA 20186                  | Own       | N/A   | N/A        | N/A   |
| Bealeton Office<br>US Rt. 17 & Station<br>Dr.<br>Bealeton, VA 22712          | Own       | N/A   | N/A        | N/A   |
| Haymarket Property<br>Market Square at<br>Haymarket<br>Haymarket, VA 20169   | Lease     | \$150,000 for first 12<br>months of occupancy<br><br>and increasing 3%<br>annually.   | 2025       | Two additional<br>options for 5 years<br><br>each |

|  |       |   |      |                                       |
|--|-------|---|------|---------------------------------------|
| Bristow Property<br>Bristow Shopping<br>Center<br>10250 Bristow Center<br>Drive<br>Bristow, VA 20136 | Lease | \$150,000 for first 12<br>months of occupancy<br><br>and increasing 3%<br>annually. | 2018 | Two additional<br>options for 5 years |
|--|-------|---|------|---------------------------------------|

\* The Bank and the Company occupy this location.

All of these properties are in good operating condition and are adequate for the Company's and the Bank's present and anticipated future needs. The Bank maintains comprehensive general liability and casualty loss insurance covering its properties and activities conducted in or about its properties. Management believes this insurance provides adequate protection for liabilities or losses that might arise out of the ownership and use of these properties.

#### ITEM LEGAL PROCEEDINGS

3.

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 that, in the opinion of management, may materially impact the financial condition of either entity.



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ITEM 4.

REMOVED AND RESERVED

PART II

ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND  
5. ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common stock trades on the NASDAQ Capital Market of the NASDAQ Stock Market LLC ("NASDAQ") under the symbol "FBSS". As of March 10, 2011, there were 3,669,758 shares outstanding of the Company's common stock, which is the Company's only class of stock outstanding. These shares were held by approximately 417 holders of record. As of March 10, 2011, the closing market price of the Company's common stock was \$13.33.

The Company's five year stock performance graph is set forth below:

| Index                     | Period Ending |           |          |          |          |          |
|---------------------------|---------------|-----------|----------|----------|----------|----------|
|                           | 12/31/05      | 12/31/06  | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 |
| Fauquier Bankshares, Inc. | \$ 100.00     | \$ 103.20 | \$ 73.05 | \$ 57.43 | \$ 59.14 | \$ 65.13 |
| NASDAQ Composite          | 100.00        | 110.39    | 122.15   | 73.32    | 106.57   | 125.91   |
| SNL Bank \$500M-\$1B      | 100.00        | 113.73    | 91.14    | 58.40    | 55.62    | 60.72    |

The following table sets forth the high and low sales prices as reported by NASDAQ for the Company's common stock and the amounts of the cash dividends paid for each full quarterly period within the two most recent fiscal years.

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|             | 2010     |          | 2009     |          | Dividends per share |         |
|-------------|----------|----------|----------|----------|---------------------|---------|
|             | High     | Low      | High     | Low      | 2010                | 2009    |
| 1st Quarter | \$ 15.94 | \$ 12.33 | \$ 14.00 | \$ 8.96  | \$ 0.20             | \$ 0.20 |
| 2nd Quarter | \$ 18.00 | \$ 14.34 | \$ 16.95 | \$ 10.64 | \$ 0.20             | \$ 0.20 |
| 3rd Quarter | \$ 16.50 | \$ 12.00 | \$ 15.00 | \$ 12.90 | \$ 0.20             | \$ 0.20 |
| 4th Quarter | \$ 14.00 | \$ 12.45 | \$ 15.74 | \$ 11.76 | \$ 0.12             | \$ 0.20 |

The Company's future dividend policy is subject to the discretion of the Board of Directors ("the Board") and will depend upon a number of factors, including future earnings, financial condition, cash and capital requirements, and general business conditions. The Company's ability to pay cash dividends will depend entirely upon the Bank's ability to pay dividends to the Company. Transfers of funds from the Bank to the Company in the form of loans, advances and cash dividends are restricted by federal and state regulatory authorities. As of December 31, 2010, the aggregate amount of unrestricted funds that could be transferred from the Bank to the Company without prior regulatory approval totaled \$3.46 million.

In September 1998, the Company announced a stock repurchase program for its common stock. Initially, the program authorized the Company to repurchase up to 73,672 shares of its common stock through December 31, 1999. Annually, the Board resets the amount of shares authorized to be repurchased during the year under the buyback program. On January 21, 2010, the Board authorized the Company to repurchase up to 107,840 shares (3% of the shares of common stock outstanding on January 1, 2010) beginning January 1, 2010. No shares of common stock were repurchased during 2010.

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## ITEM 6.

## SELECTED FINANCIAL DATA

The selected consolidated financial data set forth below should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operation” and the consolidated financial statements and accompanying notes included elsewhere in this report. The historical results are not necessarily indicative of results to be expected for any future period.

## SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

|   | For the Year Ended December 31, |          |          |          |          |
|---|---------------------------------|----------|----------|----------|----------|
|   | 2010                            | 2009     | 2008     | 2007     | 2006     |
| <b>EARNINGS STATEMENT DATA:</b>                     |                                 |          |          |          |          |
| Interest income                                     | \$28,330                        | \$28,074 | \$28,839 | \$31,194 | \$30,394 |
| Interest expense                                    | 6,124                           | 6,799    | 9,388    | 12,268   | 10,902   |
| Net interest income                                 | 22,206                          | 21,275   | 19,451   | 18,926   | 19,492   |
| Provision for loan losses                           | 2,075                           | 1,710    | 3,227    | 717      | 360      |
| Net interest income after provision for loan losses | 20,131                          | 19,565   | 16,224   | 18,209   | 19,132   |
| Noninterest income                                  | 5,568                           | 5,153    | 5,928    | 5,774    | 5,635    |
| Securities gains (losses)                           | (863 )                          | (772 )   | (335 )   | -        | (83 )    |
| Noninterest expense                                 | 20,076                          | 19,373   | 16,798   | 16,943   | 16,617   |
| Income before income taxes                          | 4,760                           | 4,573    | 5,019    | 7,040    | 8,067    |
| Income taxes  | 1,093                           | 1,156    | 1,366    | 2,087    | 2,463    |
| Net income  | \$3,667                         | \$3,417  | \$3,653  | \$4,953  | \$5,604  |

**PER SHARE DATA:**

|                                    |           |           |           |           |           |
|------------------------------------|-----------|-----------|-----------|-----------|-----------|
| Net income per share, basic        | \$1.01    | \$0.95    | \$1.04    | \$1.41    | \$1.61    |
| Net income per share, diluted      | \$1.01    | \$0.95    | \$1.03    | \$1.39    | \$1.56    |
| Cash dividends                     | \$0.72    | \$0.80    | \$0.80    | \$0.79    | \$0.745   |
| Average basic shares outstanding   | 3,627,016 | 3,593,337 | 3,525,821 | 3,504,761 | 3,472,217 |
| Average diluted shares outstanding | 3,643,109 | 3,602,831 | 3,557,677 | 3,563,343 | 3,582,241 |
| Book value at period end           | \$12.13   | \$11.86   | \$11.64   | \$11.82   | \$11.08   |

**BALANCE SHEET DATA:**

|                                      |           |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|-----------|
| Total Assets                         | \$598,040 | \$568,482 | \$514,515 | \$489,896 | \$521,854 |
| Loans, net                           | 460,442   | 462,784   | 434,678   | 409,107   | 416,061   |
| Investment securities, at fair value | 49,926    | 40,467    | 37,839    | 37,377    | 40,353    |
| Deposits                             | 520,056   | 465,987   | 400,294   | 404,559   | 416,071   |
| Shareholders' equity                 | 44,106    | 42,639    | 41,488    | 41,828    | 38,534    |

**PERFORMANCE RATIOS:**

|                          |       |   |       |   |       |   |       |   |       |   |
|--------------------------|-------|---|-------|---|-------|---|-------|---|-------|---|
| Net interest margin(1)   | 4.14  | % | 4.30  | % | 4.25  | % | 4.19  | % | 4.33  | % |
| Return on average assets | 0.63  | % | 0.64  | % | 0.73  | % | 1.01  | % | 1.14  | % |
| Return on average equity | 8.34  | % | 8.08  | % | 8.65  | % | 12.16 | % | 14.86 | % |
| Dividend payout          | 71.31 | % | 84.19 | % | 78.13 | % | 56.46 | % | 46.21 | % |
| Efficiency ratio(2)      | 72.81 | % | 73.88 | % | 65.43 | % | 67.90 | % | 66.19 | % |

**ASSET QUALITY RATIOS:**

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|  |        |   |        |   |        |   |        |   |        |   |
|--|--------|---|--------|---|--------|---|--------|---|--------|---|
| Allowance for loan losses to period end loans                | 1.35   | % | 1.17   | % | 1.09   | % | 1.01   | % | 1.07   | % |
| Allowance for loan losses to period end non-performing loans | 299.10 | % | 160.76 | % | 395.70 | % | 219.57 | % | 278.05 | % |
| Non-performing assets to period end total assets             | 0.92   | % | 1.24   | % | 0.83   | % | 0.43   | % | 0.33   | % |
| Non-performing loans to period end loans                     | 0.45   | % | 0.73   | % | 0.27   | % | 0.46   | % | 0.39   | % |
| Net charge-offs to average loans                             | 0.27   | % | 0.22   | % | 0.62   | % | 0.24   | % | 0.03   | % |

**CAPITAL RATIOS:**

|                                   |       |   |       |   |       |   |       |   |       |   |
|-----------------------------------|-------|---|-------|---|-------|---|-------|---|-------|---|
| Leverage                          | 8.55  | % | 8.68  | % | 9.37  | % | 9.49  | % | 9.54  | % |
| <b>Risk Based Capital Ratios:</b> |       |   |       |   |       |   |       |   |       |   |
| Tier 1 capital                    | 11.30 | % | 10.97 | % | 11.38 | % | 11.90 | % | 11.80 | % |
| Total capital                     | 12.55 | % | 12.21 | % | 12.52 | % | 12.98 | % | 12.90 | % |

(1) Net interest margin is calculated as fully taxable equivalent net interest income divided by average earning assets and represents the Company's net yield on its earning assets.

(2) Efficiency ratio is computed by dividing non-interest expense by the sum of fully taxable equivalent net interest income and non-interest income. Gains and losses on the sale or impairment of securities and the gain on cancellation of property rights are excluded from non-interest income in the calculation of this ratio.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

FORWARD-LOOKING STATEMENTS

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

For additional discussion of risk factors that may cause our actual future results to differ materially from the results indicated within forward-looking statements, please see "Risk Factors" in Item 1A of this report.

CRITICAL ACCOUNTING POLICIES

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

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

The Company's allowance for loan losses has two basic components: the specific allowance and the general allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance for larger balance, non-homogeneous loans. The specific allowance uses various techniques to arrive at an estimate of loss. First, analysis of the borrower's overall

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

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

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

## EXECUTIVE OVERVIEW

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

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

Net income of \$3.67 million in 2010 was a 7.3% increase from the 2009 net income of \$3.42 million. 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. Loans, net of reserve, decreased 0.5% from year-end 2009 to year-end 2010, compared with an increase of 6.5% from year-end 2008 to year-end 2009. Deposits increased 11.6% from year-end 2009 to year-end 2010, compared with an increase of 16.4% from year-end 2008 to year-end 2009. The market value of assets under WMS management increased 0.6% from 2009 to 2010, but increased 24.6% from 2008 to 2009. The changes in assets under WMS management reflect both the changes in the overall U.S. and international bond and stock markets, as well as the increase in WMS customers.

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, 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 in 2011 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 a flat or inverted yield curve. A steeper yield curve is projected to result in an increase in net interest income, while a flatter or inverted yield curve is projected to result in a decrease in net interest income. The Bank is also subject to a moderate decline in net interest income due to the overall increase in market interest rates.



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The Bank's non-performing assets totaled \$5.5 million or 0.92% of total assets at December 31, 2010, as compared with \$7.1 million or 1.24% of total assets at December 31, 2009. The provision for loan losses was \$2.08 million for 2010 compared with \$1.71 million for 2009. Loan chargeoffs, net of recoveries, totaled \$1.25 million or 0.27% of total average loans for 2010, compared with \$1.01 million or 0.22% of total average loans for 2009.

Management seeks to continue the expansion of its branch network. The Bank opened new branch offices in Bristow, Virginia and Haymarket, Virginia, its ninth and tenth full-service branch offices, respectively, during 2009. The Bank is looking toward these new retail markets for growth in deposits and WMS income. Management seeks to increase the level of its fee income WMS through the increase of its market share within its marketplace.

The following table presents a quarterly summary of earnings for the last two years.

**EARNINGS**  
(In Thousands, except Per Share Data)

|   | Three Months Ended 2010 |         |         |         | Three Months Ended 2009 |         |         |         |
|---|-------------------------|---------|---------|---------|-------------------------|---------|---------|---------|
|   | Dec. 31                 | Sep. 30 | June 30 | Mar. 31 | Dec. 31                 | Sep. 30 | June 30 | Mar. 31 |
| Interest income                                     | \$7,030                 | \$7,128 | \$7,105 | \$7,068 | \$7,273                 | \$7,136 | \$6,858 | \$6,807 |
| Interest expense                                    | 1,445                   | 1,562   | 1,550   | 1,568   | 1,591                   | 1,624   | 1,712   | 1,872   |
| Net Interest Income                                 | 5,585                   | 5,566   | 5,555   | 5,500   | 5,682                   | 5,512   | 5,146   | 4,935   |
| Provision for loan losses                           | 625                     | 700     | 375     | 375     | 790                     | 360     | 360     | 200     |
| Net interest income after provision for loan losses | 4,960                   | 4,866   | 5,180   | 5,125   | 4,892                   | 5,152   | 4,786   | 4,735   |
| Other income  | 1,495                   | 1,480   | 1,349   | 1,244   | 1,290                   | 1,357   | 1,392   | 1,115   |
| Securities gains (losses)                           | (437 )                  | (37 )   | (2 )    | (387 )  | (360 )                  | (246 )  | (166 )  | -       |
| Other expense                                       | 4,993                   | 4,989   | 5,161   | 4,934   | 4,778                   | 4,984   | 5,016   | 4,585   |
| Income before income taxes                          | 1,025                   | 1,320   | 1,366   | 1,048   | 1,044                   | 1,279   | 996     | 1,265   |
| Income tax expense                                  | 155                     | 338     | 355     | 244     | 219                     | 323     | 272     | 342     |
| Net income  | \$870                   | \$982   | \$1,011 | \$804   | \$825                   | \$956   | \$724   | \$923   |
| Net income per share, basic                         | \$0.24                  | \$0.27  | \$0.28  | \$0.22  | \$0.22                  | \$0.27  | \$0.20  | \$0.26  |
| Net income per share, diluted                       | \$0.24                  | \$0.27  | \$0.28  | \$0.22  | \$0.22                  | \$0.26  | \$0.26  | \$0.28  |

**2010 COMPARED WITH 2009**

Net income of \$3.67 million in 2010 was a 7.3% increase from 2009 net income of \$3.42 million. Earnings per share on a fully diluted basis were \$1.01 in 2010 compared to \$0.95 in 2009. Profitability as measured by return on average equity increased from 8.08% in 2009 to 8.34% in 2010. Profitability as measured by return on average assets decreased from 0.64% in 2009 to 0.63% in 2010. The year to year increase in net income was primarily due to the \$931,000 increase in net interest income and \$324,000 increase in other income from 2009 to 2010, partially offset by

the \$1.02 million increase in total other expenses.

#### 2009 COMPARED WITH 2008

Net income of \$3.42 million in 2009 was a 6.4% decrease from 2008 net income of \$3.65 million. Earnings per share on a fully diluted basis were \$0.95 in 2009 compared to \$1.03 in 2008. Profitability as measured by return on average equity decreased from 8.65% in 2008 to 8.08% in 2009. Profitability as measured by return on average assets decreased from 0.73% in 2008 to 0.64% in 2009. The year to year decline in net income was primarily due to the \$2.68 million increase in operating expenses from 2008 to 2009, partially offset by the \$1.83 million increase in net interest income.

#### NET INTEREST INCOME AND EXPENSE

##### 2010 COMPARED WITH 2009

Net interest income increased \$931,000 or 4.4% to \$22.21 million for the year ended December 31, 2010 from \$21.28 million for the year ended December 31, 2009. The increase in net interest income was due the impact of total average earning assets increasing from \$502.6 million in 2009 to \$547.0 million in 2010, partially offset by the Company's net interest margin decreasing from 4.30% in 2009 to 4.14% in 2010. The percentage of average earning assets to total assets decreased from 93.8% in 2009 to 93.2% in 2010.

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Total interest income increased \$256,000 or 0.9% to \$28.33 million in 2010 from \$28.07 million in 2009. This increase was due to the increase in total average earning assets of \$44.4 million or 8.8%, from 2009 to 2010, partially offset by the 40 basis point decrease in the average yield on assets. The yield on earning assets declined from 5.66% in 2009 to 5.26% in 2010 due to the decline in market interest rates in the economy at large over the last three years, as well as the increase of lower yielding non-loan earning assets. Average non-loan earning assets represented 14.5% of total average earning assets in 2010 compared with 9.7% of total average earning assets in 2009.

Average total loan balances increased 3.0% from \$454.1 million in 2009 to \$467.7 million in 2010. The tax-equivalent average yield on loans decreased to 5.81% in 2010 compared with 5.88% in 2009. Together, this resulted in a \$376,000 increase in interest and fee income from loans for 2010 compared with 2009. On a tax-equivalent basis, the year-to-year increase in interest and fee income on loans was \$473,000.

Average investment security balances increased \$8.2 million from \$37.3 million in 2009 to \$45.5 million in 2010. The tax-equivalent average yield on investments decreased from 4.57% in 2009 to 3.35% in 2010. Together, there was a decrease in interest and dividend income on security investments of \$173,000 or 11.0%, from \$1.58 million in 2009 to \$1.41 million in 2010. On a tax-equivalent basis, the year-to-year decrease in interest and dividend income on security investments was \$179,000.

Interest income on deposits at other banks increased from \$20,000 in 2009 to \$73,000 in 2010 due to the increase in average balances from \$11.1 million in 2009 to \$33.8 million in 2010. In addition, the interest rates paid on these deposits increased from 0.18% in 2009 to 0.22% in 2010.

Total interest expense decreased \$675,000 or 9.9% from \$6.80 million in 2009 to \$6.12 million in 2010 primarily due to the decline in market interest rates in the economy. Interest paid on deposits decreased \$563,000 or 10.0% from \$5.60 million in 2009 to \$5.04 million in 2010. Average NOW deposit balances increased \$41.7 million from 2009 to 2010 while the average rate on NOW accounts increased from 0.46% to 0.56%, resulting in \$316,000 more interest expense in 2010. Average money market account deposit balances decreased \$1.8 million from 2009 to 2010 while the average rate on money market account deposits decreased from 0.81% to 0.69% resulting in \$94,000 less interest expense in 2010. Average time deposit balances increased \$13.7 million from 2009 to 2010 while the average rate on time deposits decreased from 2.55% to 1.92%, resulting in a decrease of \$850,000 in interest expense from 2009 to 2010.

Interest expense on federal funds purchased decreased \$40,000 from 2009 to 2010 due to the decline in the average rate paid from 1.19% in 2009 to 0.79% in 2010, as well as the decline in average federal funds borrowed from \$3.5 million in 2009 to \$169,000 in 2010. Interest expense on FHLB of Atlanta advances decreased \$80,000 from 2009 to 2010 due to the \$16.4 million decrease in average FHLB advances over the same period. The average rate on total interest-bearing liabilities decreased from 1.61% in 2009 to 1.30% in 2010.

**2009 COMPARED WITH 2008**

Net interest income increased \$1.83 million or 9.4% to \$21.28 million for the year ended December 31, 2009 from \$19.45 million for the year ended December 31, 2008. The increase in net interest income was due to the Company's net interest margin increasing from 4.25% in 2008 to 4.30% in 2009, and the impact of total average earning assets increasing from \$465.4 million in 2008 to \$502.6 million in 2009. The percentage of average earning assets to total assets increased in 2009 to 93.8% from 92.9% in 2008.

Total interest income decreased \$764,000 or 2.6% to \$28.07 million in 2009 from \$28.84 million in 2008. This decrease was due to the 61 basis point decrease in the average yield on assets, partially offset by the increase in total average earning assets of \$37.2 million or 8.0%, from 2008 to 2009. The yield on earning assets declined from 6.27% in 2008 to 5.66% in 2009 due to the decline in market interest rates in the economy at large over the last two years.

Average loan balances increased 6.9% from \$424.7 million in 2008 to \$454.1 million in 2009. The tax-equivalent average yield on loans decreased to 5.88% in 2009 compared with 6.41% in 2008. Together, this resulted in a \$471,000 decrease in interest and fee income from loans for 2009 compared with 2008.

Average investment security balances decreased \$146,000 from \$37.4 million in 2008 to \$37.3 million in 2009. The tax-equivalent average yield on investments decreased from 5.20% in 2008 to 4.57% in 2009. Together, there was a decrease in interest and dividend income on security investments of \$244,000 or 13.4%, from \$1.83 million in 2008 to \$1.58 million in 2009. On a tax-equivalent basis, the year-to-year decrease in interest and dividend income on security investments was \$242,000.

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Interest income on deposits at other banks decreased from \$36,000 in 2008 to \$20,000 in 2009 due to the decline in interest rates paid on these deposits from 1.77% in 2008 to 0.18% in 2009. Interest income on federal funds sold decreased from \$33,000 during 2008 to less than \$1,000 during 2009 as average balances and yield declined \$1.1 million and 244 basis points, respectively, from 2008 to 2009.

Total interest expense decreased \$2.59 million or 27.6% from \$9.39 million in 2008 to \$6.80 million in 2009 primarily due to the decline in market interest rates in the economy. Interest paid on deposits decreased \$1.70 million or 23.3% from \$7.30 million in 2008 to \$5.60 million in 2009. Average time deposit balances increased \$55.8 million from 2008 to 2009 while the average rate on time deposits decreased from 3.67% to 2.55%, resulting in an increase of \$39,000 in interest expense from 2008 to 2009. Average NOW deposit balances decreased \$5.7 million from 2008 to 2009 while the average rate on NOW accounts decreased from 0.95% to 0.46% resulting in \$439,000 less interest expense in 2009. Average money market account deposit balances decreased \$24.0 million from 2008 to 2009 while the average rate on money market account deposits decreased from 2.03% to 0.81%, resulting in \$1.30 million less interest expense in 2009.

Interest expense on federal funds purchased decreased \$77,000 from 2008 to 2009 due to the decline in the average rate paid from 2.18% in 2008 to 1.19% in 2009, as well as the decline in average federal funds borrowed from \$5.4 million in 2008 to \$3.5 million in 2009. Interest expense on FHLB of Atlanta advances decreased \$719,000 from 2008 to 2009 due to the decline in the average rate paid from 3.66% in 2008 to 1.96% in 2009, partially offset by the \$5.2 million increase in average FHLB advances. The average rate on total interest-bearing liabilities decreased from 2.42% in 2008 to 1.61% in 2009.

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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 EXPENSES, AND AVERAGE YIELDS AND RATES**  
(Dollars In Thousands)

|  | 12 Months Ended<br>December 31, 2010 |                    |                 | 12 Months Ended<br>December 31, 2009 |                    |                 | 12 Months Ended<br>December 31, 2008 |                    |                 |
|--|--------------------------------------|--------------------|-----------------|--------------------------------------|--------------------|-----------------|--------------------------------------|--------------------|-----------------|
|  | Average<br>Balances                  | Income/<br>Expense | Average<br>Rate | Average<br>Balances                  | Income/<br>Expense | Average<br>Rate | Average<br>Balances                  | Income/<br>Expense | Average<br>Rate |
| <b>ASSETS:</b>   |                                      |                    |                 |                                      |                    |                 |                                      |                    |                 |
| <b>Loans</b>   |                                      |                    |                 |                                      |                    |                 |                                      |                    |                 |
| Taxable  | \$ 450,740                           | \$ 26,206          | 5.81 %          | \$ 442,230                           | \$ 26,014          | 5.88 %          | \$ 414,000                           | \$ 26,540          | 6.41 %          |
| Tax-exempt (1)   | 13,944                               | 976                | 7.01 %          | 9,682                                | 694                | 7.18 %          | 8,304                                | 610                | 7.35 %          |
| Nonaccrual (2)   | 2,976                                | -                  |                 | 2,185                                | -                  |                 | 2,405                                | -                  |                 |
| <b>Total Loans</b>                                     | <b>467,660</b>                       | <b>27,182</b>      | <b>5.81 %</b>   | <b>454,097</b>                       | <b>26,708</b>      | <b>5.88 %</b>   | <b>424,709</b>                       | <b>27,150</b>      | <b>6.39 %</b>   |
| <b>Securities</b>                                      |                                      |                    |                 |                                      |                    |                 |                                      |                    |                 |
| Taxable  | 39,742                               | 1,180              | 2.97 %          | 31,710                               | 1,344              | 4.24 %          | 32,077                               | 1,591              | 4.96 %          |
| Tax-exempt (1)   | 5,762                                | 346                | 6.01 %          | 5,583                                | 361                | 6.46 %          | 5,362                                | 356                | 6.64 %          |
| <b>Total securities</b>                                | <b>45,504</b>                        | <b>1,526</b>       | <b>3.35 %</b>   | <b>37,293</b>                        | <b>1,705</b>       | <b>4.57 %</b>   | <b>37,439</b>                        | <b>1,947</b>       | <b>5.20 %</b>   |
| Deposits in banks                                      | 33,847                               | 73                 | 0.22 %          | 11,109                               | 20                 | 0.18 %          | 2,030                                | 36                 | 1.77 %          |
| Federal funds sold                                     | 9                                    | -                  | 0.24 %          | 79                                   | -                  | 0.25 %          | 1,227                                | 33                 | 2.69 %          |
| <b>Total earning assets</b>                            | <b>547,020</b>                       | <b>28,781</b>      | <b>5.26 %</b>   | <b>502,578</b>                       | <b>28,433</b>      | <b>5.66 %</b>   | <b>465,405</b>                       | <b>29,166</b>      | <b>6.27 %</b>   |
| Less: Reserve for<br>loan losses                       | (5,680 )                             |                    |                 | (5,115 )                             |                    |                 | (4,359 )                             |                    |                 |
| Cash and due from<br>banks                             | 5,693                                |                    |                 | 5,536                                |                    |                 | 14,115                               |                    |                 |
| Bank premises and<br>equipment, net                    | 14,504                               |                    |                 | 10,967                               |                    |                 | 8,226                                |                    |                 |
| Other real estate<br>owned                             | 2,507                                |                    |                 | 2,365                                |                    |                 | 438                                  |                    |                 |
| Other assets   | 22,594                               |                    |                 | 19,184                               |                    |                 | 17,284                               |                    |                 |
| <b>Total Assets</b>                                    | <b>\$ 586,638</b>                    |                    |                 | <b>\$ 535,515</b>                    |                    |                 | <b>\$ 501,109</b>                    |                    |                 |
| <b>LIABILITIES<br/>&amp; SHAREHOLDERS'<br/>EQUITY:</b> |                                      |                    |                 |                                      |                    |                 |                                      |                    |                 |
| <b>Deposits</b>  |                                      |                    |                 |                                      |                    |                 |                                      |                    |                 |
| Demand deposits  | \$ 67,386                            |                    |                 | \$ 64,098                            |                    |                 | \$ 67,541                            |                    |                 |
| <b>Interest-bearing<br/>deposits</b>                   |                                      |                    |                 |                                      |                    |                 |                                      |                    |                 |
| NOW accounts   | 120,212                              | 676                | 0.56 %          | 78,547                               | 360                | 0.46 %          | 84,294                               | 799                | 0.95 %          |
|  | 64,330                               | 441                | 0.69 %          | 66,146                               | 535                | 0.81 %          | 90,184                               | 1,830              | 2.03 %          |

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|   |            |           |        |            |           |        |            |           |        |
|---|------------|-----------|--------|------------|-----------|--------|------------|-----------|--------|
| Money market accounts                                   |            |           |        |            |           |        |            |           |        |
| Savings accounts  | 50,481     | 205       | 0.41 % | 38,190     | 141       | 0.37 % | 31,482     | 148       | 0.47 % |
| Time deposits   | 192,920    | 3,714     | 1.92 % | 179,204    | 4,563     | 2.55 % | 123,424    | 4,524     | 3.67 % |
| Total interest-bearing deposits                         |            |           |        |            |           |        |            |           |        |
|   | 427,943    | 5,036     | 1.18 % | 362,087    | 5,599     | 1.55 % | 329,384    | 7,301     | 2.22 % |
| Federal funds purchased                                 |            |           |        |            |           |        |            |           |        |
|   | 169        | 1         | 0.79 % | 3,462      | 41        | 1.19 % | 5,411      | 118       | 2.18 % |
| Federal Home Loan Bank advances                         |            |           |        |            |           |        |            |           |        |
|   | 37,206     | 970       | 2.61 % | 53,586     | 1,050     | 1.96 % | 48,398     | 1,769     | 3.66 % |
| Capital securities of subsidiary trust                  |            |           |        |            |           |        |            |           |        |
|   | 4,124      | 117       | 2.84 % | 4,124      | 109       | 2.64 % | 4,124      | 200       | 4.85 % |
| Total interest-bearing liabilities                      |            |           |        |            |           |        |            |           |        |
|   | 469,442    | 6,124     | 1.30 % | 423,259    | 6,799     | 1.61 % | 387,317    | 9,388     | 2.42 % |
| Other liabilities                                       |            |           |        |            |           |        |            |           |        |
|   | 5,813      |           |        | 5,846      |           |        | 4,038      |           |        |
| Shareholders' equity                                    |            |           |        |            |           |        |            |           |        |
|   | 43,997     |           |        | 42,312     |           |        | 42,213     |           |        |
| Total Liabilities & Shareholders' Equity                |            |           |        |            |           |        |            |           |        |
|   | \$ 586,638 |           |        | \$ 535,515 |           |        | \$ 501,109 |           |        |
| Net interest spread                                     |            |           |        |            |           |        |            |           |        |
|   |            | \$ 22,657 | 3.96 % |            | \$ 21,634 | 4.05 % |            | \$ 19,778 | 3.84 % |
| Interest expense as a percent of average earning assets |            |           |        |            |           |        |            |           |        |
|   |            |           | 1.12 % |            |           | 1.35 % |            |           | 2.02 % |
| Net interest margin                                     |            |           |        |            |           |        |            |           |        |
|   |            |           | 4.14 % |            |           | 4.30 % |            |           | 4.25 % |

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

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

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## RATE/VOLUME ANALYSIS

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

RATE / VOLUME VARIANCE  
(In Thousands)

|  | 2010 Compared to 2009 |                  |             | 2009 Compared to 2008 |                  |             |
|--|-----------------------|------------------|-------------|-----------------------|------------------|-------------|
|  | Change                | Due to<br>Volume | Due to Rate | Change                | Due to<br>Volume | Due to Rate |
| <b>INTEREST INCOME</b>   |                       |                  |             |                       |                  |             |
| Loans; taxable   | \$192                 | \$501            | \$(309 )    | \$(527 )              | \$1,810          | \$(2,337 )  |
| Loans; tax-exempt (1)  | 282                   | 305              | (23 )       | 85                    | 101              | (16 )       |
| Securities; taxable  | (164 )                | 340              | (504 )      | (247 )                | (18 )            | (229 )      |
| Securities; tax-exempt (1)   | (15 )                 | 12               | (27 )       | 5                     | 15               | (10 )       |
| Deposits in banks  | 53                    | 41               | 12          | (16 )                 | 161              | (177 )      |
| Federal funds sold   | -                     | -                | -           | (33 )                 | (31 )            | (2 )        |
| Total Interest Income  | 348                   | 1,199            | (851 )      | (733 )                | 2,038            | (2,771 )    |
| <b>INTEREST EXPENSE</b>  |                       |                  |             |                       |                  |             |
| NOW accounts   | 316                   | 191              | 125         | (439 )                | (54 )            | (385 )      |
| Money market accounts  | (94 )                 | (15 )            | (79 )       | (1,294 )              | (488 )           | (806 )      |
| Savings accounts   | 64                    | 45               | 19          | (7 )                  | 32               | (39 )       |
| Time deposits  | (849 )                | 349              | (1,198 )    | 38                    | 2,045            | (2,007 )    |
| Federal funds purchased and securities sold under agreements to repurchase | (40 )                 | (39 )            | (1 )        | (77 )                 | (43 )            | (34 )       |
| Federal Home Loan Bank advances  | (80 )                 | (321 )           | 241         | (719 )                | 190              | (909 )      |
| Capital securities of subsidiary trust                                     | 8                     | -                | 8           | (91 )                 | -                | (91 )       |
| Total Interest Expense   | (675 )                | 210              | (885 )      | (2,589 )              | 1,682            | (4,271 )    |
| Net Interest Income  | \$1,023               | \$989            | \$34        | \$1,856               | \$356            | \$1,500     |

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

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

The provision for loan losses was \$2.08 million for 2010, \$1.71 million for 2009, and \$3.23 million for 2008. The amount of the provision for loan loss for 2010, 2009, and 2008 was based upon management's continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank's delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. Greater weight is given to the loss history by loan category, prolonged changes in portfolio delinquency trends by loan category, and changes in economic trends. There can be no assurances, however, that



future losses will not exceed estimated amounts, or that increased amounts of provisions for loan losses will not be required in future periods.

The \$365,000 increase in the provision for loan losses from 2009 to 2010 was largely in response to the \$242,000 net increase in net loan charge-offs in 2010 from 2009. The \$1.52 million decrease in the provision for loan losses from 2008 to 2009 was largely in response to the \$1.62 million decrease in net loan charge-offs in 2009 from 2008. Loan charge-offs, net of recoveries, totaled \$1.3 million for 2010, \$1.0 million for 2009, \$2.6 million for 2008. Loan charge-offs during 2009 were largely provided for in the allowance during 2008.

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### LOAN PORTFOLIO

At December 31, 2010, 2009, and 2008, net loans accounted for 77.0%, 81.4%, and 84.5%, of total assets, respectively, and were the largest category of the Company's earning assets. Loans are shown on the balance sheets net of unearned discounts and the allowance for loan losses. Interest is computed by methods that result in level rates of return on principal. Loans are charged-off when deemed by management to be uncollectible, after taking into consideration such factors as the current financial condition of the customer and the underlying collateral and guarantees.

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. The 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 there is an identified weakness that makes it probable that the Bank will not be able 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 necessarily 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.

The Bank considers all consumer installment loans and residential mortgage loans to be homogenous loans. These loans are not subject to individual impairment under authoritative accounting guidance.

### ASSET QUALITY

Non-performing assets, in most cases, consist of loans, other real estate owned, repossessed property such as automobiles and pooled trust preferred securities that are 90 days or more past due and for which the accrual of interest has been discontinued. Management evaluates all loans and investments 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 payments received on such loans are applied as a reduction of the loan principal balance.

A Troubled Debt Restructuring ("TDR") identification process has been established using a template of questions that determine whether a debtor is experiencing financial difficulty and, if so, whether the bank has granted a concession to a borrower by modifying the loan. Then, mitigating factors are evaluated to determine a final conclusion as to the whether the loan is a TDR. One loan in the portfolio has been identified as a TDR. This loan, with

a balance of \$255,000, is a commercial and industrial loan, secured by business assets. The loan was originated during December 2007 and was modified during June 2010. At December 31, 2010, this loan was not performing in accordance with its modified terms, and is on non-accrual status and an appropriate specific reserve has been established.

Non-performing assets totaled \$5.5 million or 0.92% of total assets at December 31, 2010, as compared with \$7.1 million or 1.24% of total assets at December 31, 2009 and \$4.3 million or 0.83% of total assets at December 31, 2008. Included in non-performing assets at December 31, 2010 were \$552,000 of non-performing pooled trust preferred securities at fair value, as well as \$2.8 million of other real estate owned, \$2.1 million of nonaccrual loans and \$21,000 of repossessed autos.

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Non-performing loans, other real estate owned, and other repossessed assets totaled \$5.0 million or 1.05% of total loans, other real estate owned, and other repossessed assets at December 31, 2010, as compared with \$5.9 million or 1.26% of total loans, other real estate owned, and other repossessed assets at December 31, 2009 and \$4.3 million, or 0.97% of total loans, other real estate owned, and other repossessed assets at December 31, 2008.

The allowance for loan losses as a percentage of non-performing loans was 299.1%, 160.8% and 395.7% at December 31, 2010, 2009 and 2008, respectively. The reason for the decline in this coverage ratio from 2008 to 2009 was primarily due to the underlying collateral value of the new loans added to the non-performing category in 2009, and the relative levels of allowance needed for these specific loans. Specifically, non-performing loans increased \$2.2 million from 2008 to 2009 primarily due to the addition of three commercial real estate loans totaling \$2.2 million. The allowance for loan losses specifically allocated for these three loans totaled approximately \$287,000, or a coverage ratio of approximately 13%.

The number of non-performing loan relationships was ten at December 31, 2010 compared with twenty at December 31, 2009, and nineteen at December 31, 2008. The Bank's other real estate owned consists of two properties with a total value, net of cost to sell, of \$2,821,000 at December 31, 2010 compared with two properties with a total value, net of cost to sell, of \$2,480,000 at December 31, 2009 and two properties with a total value, net of cost to sell, of \$3,034,000 at December 31, 2008. At December 31, 2010, one property has a net value of approximately \$2.0 million and consists of 47 acres of undeveloped land in Opal, Virginia, and the second property has a net value of approximately \$850,000 and consists of a commercial building located in Warrenton, Virginia.

Loans that were 90 days past due and accruing interest totaled \$263,000, \$354,000 and \$102,000 at December 31, 2010, 2009, and 2008, respectively. No loss is anticipated on any loan 90 days past due and accruing interest.

Additionally, there were eight loans totaling \$979,000 at December 31, 2010 which were considered impaired and were allocated \$791,000 of specific loan loss reserves. There are no loans, other than those disclosed above as either non-performing or impaired, where information known about the borrower has caused management to have serious doubts about the borrower's ability to repay.

At December 31, 2010, there are no other interest-bearing assets that would be subject to disclosure as either non-performing or impaired.

At December 31, 2010, no concentration of loans to commercial borrowers engaged in similar activities exceeded 10% of total loans. The largest industry concentrations at December 31, 2010 were approximately 5.12% of loans to the hospitality industry (hotels, motels, inns, etc.). For more information regarding the Bank's concentration of loans collateralized by real estate, please refer to the discussion under "Risk Factors" in Item 1A of this report entitled "We have a high concentration of loans secured by real estate and the continued downturn in the real estate market, for any reason, may increase our credit losses, which would negatively affect our financial results."

Based on recently enacted regulatory guidelines, the Bank is now required to monitor the commercial investment real estate loan portfolio for: (a) concentrations above 100% of Tier 1 capital and loan loss reserve for construction and land loans and (b) 300% for permanent investor real estate loans. As of December 31, 2010, construction and land loans are \$27.4 million or 50.0% of the concentration limit, while permanent investor real estate loans (by NAICS code) are \$122.8 million or 224.0% of the concentration level.

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Total loans on the balance sheet are comprised of the following classifications as of December 31, 2010, 2009, 2008, 2007, and 2006.

|   | LOAN PORTFOLIO<br>(In Thousands) |           |              |           |           |
|---|----------------------------------|-----------|--------------|-----------|-----------|
|   | 2010                             | 2009      | December 31, |           |           |
|   |                                  |           | 2008         | 2007      | 2006      |
| Loans secured by real estate:   |                                  |           |              |           |           |
| Construction  | \$27,390                         | \$33,003  | \$38,037     | \$37,204  | \$33,662  |
| 1-4 family residential  | 136,137                          | 144,274   | 135,108      | 134,660   | 131,208   |
| Home equity lines of credit   | 51,023                           | 49,435    | 40,683       | 36,328    | 37,102    |
| Commercial real estate  | 215,349                          | 201,970   | 170,403      | 141,577   | 144,283   |
| Commercial and industrial loans (except those secured by real estate) | 29,819                           | 29,286    | 39,985       | 38,203    | 41,508    |
| Consumer loans to individuals (except those secured by real estate)   | 7,031                            | 10,390    | 15,962       | 25,658    | 33,262    |
| Total loans   | \$466,749                        | \$468,358 | \$440,178    | \$413,630 | \$421,025 |

The following table sets forth certain information with respect to the Bank's non-accrual, restructured and past due loans, as well as foreclosed assets, at the dates indicated:

|  | NON-PERFORMING ASSETS AND LOANS CONTRACTUALLY PAST DUE<br>(Dollars In Thousands) |         |                 |         |         |
|--|--|---------|-----------------|---------|---------|
|  | 2010   | 2009    | At December 31, |         |         |
|  |  |         | 2008            | 2007    | 2006    |
| Non-accrual loans  | \$2,109  | \$3,410 | \$1,208         | \$1,906 | \$1,608 |
| Restructured loans*  | -  | -       | -               | -       | -       |
| Other real estate owned  | 2,821  | 2,480   | 3,034           | -       | -       |
| Other repossessed assets owned                                     | 21   | 54      | 33              | 222     | 140     |
| Non-performing corporate bond investments, at fair value           | \$552  | \$1,126 | -               | -       | -       |
| Total non-performing assets  | \$5,503  | \$7,070 | \$4,275         | \$2,128 | \$1,748 |
| Loans past due 90 days accruing interest                           | \$263  | \$354   | \$102           | \$770   | \$1     |
| Allowance for loan losses as percentage of total loans, period end | 1.35   | % 1.17  | % 1.09          | % 1.02  | % 1.07  |
| Non-performing loans to total loans, period end                    | 0.45   | % 0.73  | % 0.27          | % 0.46  | % 0.38  |

|   |        |   |        |   |        |   |        |   |        |   |
|---|--------|---|--------|---|--------|---|--------|---|--------|---|
| Allowance for loan losses as percentage of non-performing loans, period end   | 299.10 | % | 160.76 | % | 395.70 | % | 219.57 | % | 278.05 | % |
| Non-performing loans, other real estate owned and other repossessed assets as percentage of total loans, other real estate owned and other repossessed assets, period end | 1.05   | % | 1.26   | % | 0.97   | % | 0.51   | % | 0.42   | % |
| Non-performing assets as percentage of total assets, period end   | 0.92   | % | 1.24   | % | 0.83   | % | 0.43   | % | 0.33   | % |

\*Restructured loans on non-accrual status are included with non-accrual loans and not restructured loans. At December 31, 2010 there was one loan totaling \$255,000 that was both restructured and on non-accrual status.

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

Age Analysis of Past Due Loans  
For the Year Ended December 31, 2010  
(in thousands)

|                            | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>than 90<br>Days | Total Past<br>Due | Total Loans | Past Due<br>as<br>percentage<br>of Loans |   |
|----------------------------|------------------------|------------------------|----------------------------|-------------------|-------------|--|---|
| Secured by real estate:    |                        |                        |                            |                   |             |  |   |
| Construction               | \$-                    | \$-                    | \$-                        | \$-               | \$27,390    | 0.00                                     | % |
| 1-4 family residential     | 1,208                  | 552                    | 502                        | 2,262             | 136,137     | 1.66                                     | % |
| Home equity line of credit | 363                    | 352                    | 612                        | 1,327             | 51,023      | 2.60                                     | % |
| Commercial real estate     | 428                    | -                      | 187                        | 615               | 215,349     | 0.29                                     | % |
| Commercial and industrial  | 84                     | 99                     | 96                         | 279               | 29,819      | 0.94                                     | % |
| Consumer                   | 100                    | -                      | -                          | 100               | 7,031       | 1.42                                     | % |
|                            | \$2,183                | \$1,003                | \$1,397                    | \$4,583           | \$466,749   | 0.98                                     | % |

For the Year Ended December 31, 2009

|                            | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>than 90<br>Days | Total Past<br>Due | Total Loans | Past Due<br>as<br>percentage<br>of Loans |   |
|----------------------------|------------------------|------------------------|----------------------------|-------------------|-------------|--|---|
| Secured by real estate:    |                        |                        |                            |                   |             |  |   |
| Construction               | \$-                    | \$-                    | \$-                        | \$-               | \$33,003    | 0.00                                     | % |
| 1-4 family residential     | 1,876                  | -                      | 432                        | 2,308             | 144,274     | 1.60                                     | % |
| Home equity line of credit | 102                    | 469                    | -                          | 571               | 49,435      | 1.16                                     | % |
| Commercial real estate     | 354                    | 123                    | 1,720                      | 2,197             | 201,970     | 1.09                                     | % |
| Commercial and industrial  | 781                    | 169                    | 764                        | 1,714             | 29,286      | 5.85                                     | % |
| Consumer                   | 137                    | 30                     | 41                         | 208               | 10,390      | 2.00                                     | % |
|                            | \$3,250                | \$791                  | \$2,957                    | \$6,998           | \$468,358   | 1.49                                     | % |

For the Year Ended December 31, 2008

|                            | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>than 90<br>Days | Total Past<br>Due | Total Loans | Past Due<br>as<br>percentage<br>of Loans |   |
|----------------------------|------------------------|------------------------|----------------------------|-------------------|-------------|--|---|
| Secured by real estate:    |                        |                        |                            |                   |             |  |   |
| Construction               | \$-                    | \$-                    | \$-                        | \$-               | \$38,037    | 0.00                                     | % |
| 1-4 family residential     | 1,482                  | 709                    | -                          | 2,191             | 135,108     | 1.62                                     | % |
| Home equity line of credit | 947                    | 66                     | -                          | 1,013             | 40,683      | 2.49                                     | % |
| Commercial real estate     | 1,637                  | 1,545                  | -                          | 3,182             | 170,403     | 1.87                                     | % |
| Commercial and industrial  | 268                    | 175                    | 453                        | 896               | 39,985      | 2.24                                     | % |
| Consumer                   | 245                    | 23                     | 78                         | 346               | 15,962      | 2.17                                     | % |
|                            | \$4,579                | \$2,518                | \$531                      | \$7,628           | \$440,178   | 1.73                                     | % |

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

#### ANALYSIS OF LOAN LOSS EXPERIENCE

The allowance for loan losses is maintained at a level which, in management’s judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management’s evaluation of the collectibility of the loan portfolio, credit concentration, trends in historical loss experience, specific impaired loans, and current economic conditions. Management periodically reviews the loan portfolio to determine probable credit losses related to specifically identified loans as well as credit losses inherent in the remainder of the loan portfolio. Allowances for impaired loans are generally determined based on net realizable values or the present value of estimated cash flows. The allowance is increased by a provision for loan losses, which is charged to expense and reduced by charge-offs, net of recoveries. Changes in the allowances relating to impaired loans are charged or credited to the provision for loan losses. Because of uncertainties inherent in the estimation process, management’s estimate of credit losses inherent in the loan portfolio and the related allowance remains subject to change. Additions to the allowance for loan losses, recorded as the provision for loan losses on the Company’s statements of income, are made monthly to maintain the allowance at an appropriate level based on management’s analysis of the inherent risk in the loan portfolio. The amount of the provision is a function of the level of loans outstanding, the level of non-performing loans, historical loan-loss experience, the amount of loan losses actually charged off or recovered during a given period and current national and local economic conditions.



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At December 31, 2010, 2009, 2008, 2007, and 2006, the allowance for loan losses was \$6.3 million, \$5.5 million, \$4.8 million, \$4.2 million, and \$4.5 million, respectively. As a percentage of total loans, the allowance for loan losses increased from 1.17% at December 31, 2009 to 1.35% at December 31, 2010. The allowance for loan losses equaled 299.1% of non-performing loans at December 31, 2010 compared to 160.8% one year earlier.

The following table summarizes the Bank's loan loss experience for each of the years ended December 31, 2010, 2009, 2008, 2007, and 2006, respectively:

ANALYSIS OF ALLOWANCE FOR LOAN LOSSES  
(Dollars In Thousands)

|   | Years ended December 31, |         |         |         |         |   |      |   |      |   |
|---|--------------------------|---------|---------|---------|---------|---|------|---|------|---|
|   | 2010                     | 2009    | 2008    | 2007    | 2006    |   |      |   |      |   |
| Allowance for loan losses, January 1,     | \$5,482                  | \$4,780 | \$4,185 | \$4,471 | \$4,238 |   |      |   |      |   |
| Secured by real estate:                   |                          |         |         |         |         |   |      |   |      |   |
| Construction                              | -                        | -       | 617     | -       | -       |   |      |   |      |   |
| 1-4 family residential                    | 250                      | 377     | 797     | -       | -       |   |      |   |      |   |
| Home equity line of credit                | 111                      | 129     | 10      | -       | -       |   |      |   |      |   |
| Commercial real estate                    | 632                      | 245     | -       | -       | -       |   |      |   |      |   |
| Commercial and industrial                 | 96                       | 40      | 750     | 762     | 56      |   |      |   |      |   |
| Consumer                                  | 255                      | 298     | 530     | 301     | 200     |   |      |   |      |   |
| Total loans charged-off                   | 1,344                    | 1,089   | 2,704   | 1,063   | 256     |   |      |   |      |   |
| Secured by real estate:                   |                          |         |         |         |         |   |      |   |      |   |
| Construction                              | -                        | -       | -       | -       | -       |   |      |   |      |   |
| 1-4 family residential                    | 6                        | 36      | -       | -       | -       |   |      |   |      |   |
| Home equity line of credit                | -                        | -       | -       | -       | -       |   |      |   |      |   |
| Commercial real estate                    | 10                       | 4       | -       | -       | -       |   |      |   |      |   |
| Commercial and industrial                 | 9                        | 7       | 12      | -       | 60      |   |      |   |      |   |
| Consumer                                  | 69                       | 34      | 60      | 60      | 69      |   |      |   |      |   |
| Total loans recoveries                    | 94                       | 81      | 72      | 60      | 129     |   |      |   |      |   |
| Net Charge-Offs                           | 1,250                    | 1,008   | 2,632   | 1,003   | 127     |   |      |   |      |   |
| Provision for loan losses                 | 2,075                    | 1,710   | 3,227   | 717     | 360     |   |      |   |      |   |
| Allowance for loan losses, December 31,   | \$6,307                  | \$5,482 | \$4,780 | \$4,185 | \$4,471 |   |      |   |      |   |
| Ratio of net charge-offs to average loans | 0.27                     | %       | 0.22    | %       | 0.62    | % | 0.24 | % | 0.03 | % |

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The following table allocates the allowance for loan losses at December 31, 2010, 2009, 2008, 2007, and 2006 to each loan category. The allowance has been allocated according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within the following categories of loans at the dates indicated, although the entire allowance balance is available to absorb any actual charge-offs that may occur.

**ALLOCATION OF ALLOWANCE FOR LOAN LOSSES**  
(Dollars In Thousands)

|                            | 2010                            |                                 | 2009                            |                                 | 2008                            |                                 |
|----------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
|                            | Allowance<br>for Loan<br>Losses | Percentage<br>of Total<br>Loans | Allowance<br>for Loan<br>Losses | Percentage<br>of Total<br>Loans | Allowance<br>for Loan<br>Losses | Percentage<br>of Total<br>Loans |
| Secured by real estate:    |                                 |                                 |                                 |                                 |                                 |                                 |
| Construction               | \$ 150                          | 5.87 %                          | \$ 186                          | 7.05 %                          | \$ 231                          | 8.64 %                          |
| 1-4 family residential     | 1,623                           | 29.17 %                         | 1,179                           | 30.80 %                         | 851                             | 30.69 %                         |
| Home equity line of credit | 1,106                           | 10.93 %                         | 814                             | 10.55 %                         | 475                             | 9.24 %                          |
| Commercial real estate     | 2,321                           | 46.14 %                         | 2,165                           | 43.12 %                         | 1,641                           | 38.71 %                         |
| Commercial and industrial  | 793                             | 6.39 %                          | 1,039                           | 6.25 %                          | 1,323                           | 9.08 %                          |
| Consumer                   | \$ 314                          | 1.51 %                          | \$ 99                           | 2.22 %                          | \$ 259                          | 3.63 %                          |
|                            | \$ 6,307                        | 100.00 %                        | \$ 5,482                        | 100.00 %                        | \$ 4,780                        | 100.00 %                        |

|                               | 2007                            |                                 | 2006                            |                                 |
|-------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
|                               | Allowance<br>for Loan<br>Losses | Percentage<br>of Total<br>Loans | Allowance<br>for Loan<br>Losses | Percentage<br>of Total<br>Loans |
| Secured by real estate:       |                                 |                                 |                                 |                                 |
| Construction                  | \$ 317                          | 8.99 %                          | \$ 403                          | 8.00 %                          |
| 1-4 family residential        | 402                             | 32.56 %                         | 350                             | 31.16 %                         |
| Home equity line of<br>credit | 201                             | 8.78 %                          | 125                             | 8.81 %                          |
| Commercial real estate        | 1,575                           | 34.23 %                         | 1,763                           | 34.27 %                         |
| Commercial and<br>industrial  | 1,334                           | 9.24 %                          | 1,367                           | 9.86 %                          |
| Consumer                      | 356                             | 6.20 %                          | 463                             | 7.90 %                          |
|                               | \$ 4,185                        | 100.00 %                        | \$ 4,471                        | 100.00 %                        |

**NON-INTEREST INCOME****2010 COMPARED WITH 2009**

Total non-interest income increased by \$324,000 from \$4.38 million in 2009 to \$4.71 million in 2010. Non-interest income is derived primarily from non-interest fee income, which consists primarily of fiduciary trust and estate fees, brokerage income, service charges on deposit accounts, and other fee income. Also included in non-interest income for 2010 was an impairment loss of \$1.40 million on the investment in pooled trust preferred securities, as well as losses of \$120,000 from the Bank's sale of other real estate owned. These losses were partially offset by gains on the sale of securities of \$541,000. See Note 2 "Securities" of the Notes to Consolidated Financial Statements for further discussion regarding the methodology for determining impairment on the Bank's investment in pooled trust preferred securities.

Trust and estate income increased \$161,000 or 17.9% from 2009 to 2010, primarily as the result of the increase in new trust customers as well as an increase in the market value of the assets under management. Brokerage income increased \$179,000 or 83.7% from 2009 to 2010 primarily due to increased transactions generated by the improving stock market and the addition to sales staff of one broker. Service charges on deposit accounts increased \$89,000 or 3.3% to \$2.80 million for 2010, compared with \$2.71 million for 2009 due to the increase in transaction deposit account customers. Other service charges, commissions and fees decreased \$30,000 or 2.1% from \$1.46 million in 2009 to \$1.43 million in 2010. Also included in other service charges, commissions, and income is bank-owned life insurance (“BOLI”) income, which was \$430,000 in 2010 compared with \$408,000 in 2009. Total BOLI was \$11.2 million at December 31, 2010.

Management seeks to increase the level of its future fee income from wealth management services and deposits through the increase of its market share within its marketplace. This assumes that the market value of the U.S. and international stock markets increases. Fees from deposits may decline in 2011 as the result of changes in regulations regarding fees on overdraft protection services.

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2009 COMPARED WITH 2008

Total non-interest income decreased by \$1.20 million from \$5.59 million in 2008 to \$4.38 million in 2009. Also included in non-interest income were an impairment loss of \$659,000 and \$113,000 on the investment in pooled trust preferred securities and Silverton Bank common stock, respectively, as well as losses of \$136,000 from the Bank's sale of other real estate owned. See Note 2 "Securities" of the Notes to Consolidated Financial Statements for further discussion regarding the methodology for determining impairment on the Bank's investment in pooled trust preferred securities.

Trust and estate income decreased \$140,000 or 13.6% from 2008 to 2009, primarily as the result of the decrease in the market value of the assets under management. Brokerage income decreased \$32,000 or 13.1% due to decreased transactions. Service charges on deposit accounts decreased \$66,000 or 2.4% to \$2.71 million for 2009, compared with \$2.78 million for 2008. Other service charges, commissions and fees decreased \$374,000 or 20.4% from \$1.84 million in 2008 to \$1.46 million in 2009 partially due to gains of \$122,000 in 2008 from the Bank's activities in the partial ownership in finance-related limited liability corporations that lost \$14,000 in 2009. During 2008, the Bank recognized the net gain of \$122,000 in the value of their partial ownership in four different entities, primarily a \$217,000 gain due to the Bank's ownership interest in Infinex, a full service broker/dealer. Also included in other service charges, commissions, and income is BOLI income, which was \$408,000 in 2009 compared with \$410,000 in 2008. Total BOLI was \$10.9 million at December 31, 2009.

NON-INTEREST EXPENSE

2010 COMPARED WITH 2009

Total non-interest expense increased \$704,000 or 3.6% in 2010 compared with 2009. The primary component of this was an increase in salaries and employees' benefits of \$669,000, or 6.8%. The increase in salary and benefit expense was due to the additional required funding of the Company's pension plan from the date of its termination on December 31, 2009 to the date of its payout on December 10, 2010, as well as the full year impact of the additional employees used to staff the Bristow and Haymarket branch offices. During 2009, the Company increased staff by approximately eight full-time equivalent people due to the branches opening in Bristow and Haymarket.

On December 20, 2008, the Board approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010, replaced the defined benefit pension plan with an enhanced 401(k) plan. The 401(k) expenses were \$662,000 in 2010 compared with \$154,000 in 2009. Growth in 401(k) expense after 2010 is projected to increase approximately at the same rate of increase as salaries.

The Bank expects personnel costs, consisting primarily of salary and benefits, to continue to be its largest non-interest expense. As such, the most important factor with regard to potential changes in other expenses is the expansion of staff. The cost of any additional staff expansion, however, would be expected to be offset by the increased revenue generated by the additional services that the new staff would enable the Bank to perform.

Net occupancy expense increased \$370,000 or 25.6%, and furniture and equipment expense increased \$152,000 or 13.8%, from 2009 to 2010 due to the additional expenses related to the full year impact of the new branches in Bristow and Haymarket, as well as the new branch location for the View Tree branch office.

Marketing expense decreased \$32,000 or 4.5% from 2009 to 2010 primarily due to marketing expenditures associated with the opening of the Bristow and Haymarket branch offices made in 2009 that did not reoccur in 2010.

Consulting expense, which includes legal and accounting professional fees, decreased \$259,000 or 20.1% in 2010 compared with 2009. This decrease reflects legal fees and other consulting fees associated with the 2009 annual

meeting of shareholders and a contested election of directors that did not reoccur in 2010.

Data processing expense decreased \$11,000 or 1.0% in 2010 compared with 2009. The Bank outsources much of its data processing to a third-party vendor. During 2009, the Bank changed its third party data processing vendor in an effort to improve customer service and reduce operating expenses.

The FDIC deposit insurance expense decreased from \$866,000 for 2009 to \$734,000 for 2010. The expense for 2009 included approximately \$241,000 for the FDIC's special assessment. The FDIC is required by law any time the Deposit Insurance Fund reserve ratio falls below 1.15%. The special assessment during 2009 was due to the impact of increased failures of FDIC-insured financial institutions in 2008 and 2009 on the DIF and its reserve ratio. During the fourth quarter of 2009, the Bank prepaid its FDIC assessment for 2010 through 2012. At December 31, 2010, the amount of the prepayment to be amortized through December 31, 2012 was \$1,649,000.

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Other operating expenses decreased \$55,000 or 1.8% in 2010 compared with 2009. The decrease in expense primarily reflects an expenses related to the 2009 annual meeting of shareholders and a contested election of directors related to the meeting that did not reoccur in 2010, as well as decreased non-loan charge-offs.

### 2009 COMPARED WITH 2008

Total non-interest expense increased \$2.57 million or 15.3% in 2009 compared with 2008. The primary component of this was an increase in salaries and employees' benefits of \$1.61 million, or 19.4%. The increase in salary and benefit expense was primarily due to the reintroduction of incentive compensation in 2009 compared with the elimination of all cash-based incentive compensation for 2008. Cash-based incentive compensation totaled \$537,000 for 2009 as compared with nothing in 2008 and \$596,000 in 2007. Cash-based incentives are paid based upon the Company exceeding predetermined goals established by the Company's board of directors. These predetermined goals include the Company's net income as a percentage of average equity, loan growth, and transactional deposit growth. In addition to cash-based incentives, the increase in salaries and employees' benefits also included a net increase of \$430,000 in defined benefit pension plan expense from 2008 to 2009 due to the required accounting associated with the termination of the defined benefit pension plan effective December 31, 2009.

Net occupancy expense increased \$158,000 or 12.3%, and furniture and equipment expense decreased \$77,000 or 6.6%, from 2008 to 2009. The increase in occupancy expenses primarily reflects the sale and temporary rental of the View Tree branch office during 2009.

Marketing expense increased \$87,000 or 14.1% from 2008 to 2009 primarily due to marketing expenditures associated with the opening of the Bristow and Haymarket branch offices.

Consulting expense, which includes legal and accounting professional fees, increased \$192,000 or 17.5% in 2009 compared with 2008. This increase reflects increased legal fees and other consulting fees associated with the 2009 annual meeting of shareholders and a contested election of directors related to the meeting.

Data processing expense decreased \$218,000 or 17.2% in 2009 compared with 2008. During 2009, the Bank changed its third party data processing vendor in an effort to improve customer service and reduce operating expenses.

The FDIC deposit insurance expense increased from \$291,000 for 2008 to \$866,000 for 2009, which included approximately \$241,000 for the FDIC's special assessment.

Other operating expenses increased \$252,000 or 9.0% in 2009 compared with 2008. The increase in expense primarily reflects an increase in expenses related to the 2009 annual meeting of shareholders and a contested election of directors related to the meeting, as well as increased non-loan charge-offs.

### INCOME TAXES

Income tax expense decreased by \$63,000 for the year ended December 31, 2010 compared to the year ended December 31, 2009. Income tax expense decreased by \$210,000 for the year ended December 31, 2009 compared to the year ended December 31, 2008. The effective tax rates were 23.0% for 2010, 25.3% for 2009, and 27.2% for 2008. The effective tax rate differs from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, income from the BOLI purchases, and community development tax credits. Community development tax credits increased from approximately \$23,000 and \$27,000 in 2008 and 2009, respectively, to \$105,000 in 2010.

### COMPARISON OF FINANCIAL CONDITION AT DECEMBER 31, 2010 AND DECEMBER 31, 2009

Total assets were \$598.0 million at December 31, 2010, an increase of 5.2% or \$29.5 million from \$568.5 million at December 31, 2009. Balance sheet categories reflecting significant changes included interest-bearing deposits in other banks, total loans, deposits, and FHLB advances. Each of these categories, as well as investment securities and company-obligated mandatorily redeemable capital securities of subsidiary trust, is discussed below.

**INTEREST-BEARING DEPOSITS IN OTHER BANKS.** Interest-bearing deposits in banks increased from \$20.5 million at December 31, 2009 to \$41.9 million at December 31, 2010. The increase in interest-bearing deposits in other banks was primarily the result of excess liquidity generated from deposit growth being temporarily deposited at the Federal Reserve Bank of Richmond.

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INVESTMENT SECURITIES. Total investment securities were \$46.5 million at December 31, 2010, reflecting an increase of \$9.8 million from \$36.7 million at December 31, 2009. At December 31, 2010 and 2009, all investment securities were available for sale. The valuation allowance for the available for sale portfolio had an unrealized loss, net of tax benefit, of \$2.13 million at December 31, 2010 compared with an unrealized loss, net of tax benefit, of \$1.58 million at December 31, 2009. See Note 2 "Securities" of the Notes to Consolidated Financial Statements for further discussion on the market value loss on the Bank's investment securities.

At December 31, 2010, 2009 and 2008, the carrying values of the major classifications of securities were as follows:

INVESTMENT PORTFOLIO  
(In Thousands)

|  | Available for Sale (1) |          |          |
|--|------------------------|----------|----------|
|  | 2010                   | 2009     | 2008     |
| Obligations of U.S. Government corporations and agencies | \$40,032               | \$28,729 | \$25,772 |
| Obligations of states and political subdivisions         | 5,619                  | 5,724    | 5,458    |
| Corporate Bonds  | 552                    | 1,912    | 3,138    |
| Mutual funds   | 326                    | 312      | 298      |
| FHLMC preferred stock                                    | 9                      | 15       | 6        |
| Total  | \$46,538               | \$36,692 | \$34,672 |

(1) Amounts for available-for-sale securities are based on fair value.

## ESTIMATED MATURITY OR NEXT RATE ADJUSTMENT DATE

The following is a schedule of estimated maturities or next rate adjustment date and related weighted average yields of securities at December 31, 2010:

ESTIMATED MATURITY DISTRIBUTION AND YIELDS OF SECURITIES  
(Dollars In Thousands)

|  | Due in one year<br>or less                  |       | Due after 1<br>through 5 years |          | Due after 5<br>through 10 years |       |         |      |   |
|--|---|-------|--------------------------------|----------|---------------------------------|-------|---------|------|---|
|  | Amount                                      | Yield | Amount                         | Yield    | Amount                          | Yield |         |      |   |
| Securities available for sale:                                     |   |       |                                |          |                                 |       |         |      |   |
| Obligations of U.S.<br>Government corporations and<br>agencies     | \$8   | 1.70  | %                              | \$18,193 | 1.52                            | %     | \$3,152 | 2.22 | % |
| Corporate bonds  | -   |       |                                | -        |                                 |       | -       |      |   |
| Other taxable securities   | -   |       |                                | -        |                                 |       | -       |      |   |
| Total taxable  | 8   | 1.70  | %                              | 18,193   | 1.52                            | %     | 3,152   | 2.22 | % |
| Obligations of states and<br>political subdivisions,<br>tax-exempt | -   | -     |                                | -        |                                 |       | 1,801   | 5.28 | % |
| Total securities:  | \$8   | 1.70  | %                              | \$18,193 | 1.52                            | %     | \$4,953 | 3.33 | % |
|  | Due after 10 years<br>and Equity Securities |       | Total                          |          |                                 |       |         |      |   |
|  | Amount                                      | Yield | Amount                         | Yield    |                                 |       |         |      |   |



Securities available for sale:

|  |           |      |   |           |      |   |
|--|-----------|------|---|-----------|------|---|
| Obligations of U.S. Government corporations and agencies     |           |      |   |           |      |   |
|  | \$ 18,679 | 3.19 | % | \$ 40,032 | 2.35 | % |
| Corporate bonds  | 552       | 0.00 | % | 552       | 0.00 | % |
| Other taxable securities                                     | 335       | 3.04 | % | 335       | 3.04 | % |
| Total taxable  | 19,566    | 3.10 | % | 40,919    | 2.33 | % |
| Obligations of states and political subdivisions, tax-exempt |           |      |   |           |      |   |
|  | 3,818     | 5.43 | % | 5,619     | 5.38 | % |
| Total securities:  | \$ 23,384 | 3.48 | % | \$ 46,538 | 2.70 | % |

Excluding obligations of U. S. Government corporations and agencies, no Bank security investment exceeded 10% of shareholders' equity.

LOANS. Total net loan balance after allowance for loan losses was \$460.4 million at December 31, 2010, which represents a decrease of \$2.3 million or 0.5% from \$462.8 million at December 31, 2009. Commercial real estate loans increased \$13.4 million from year-end 2009 to year-end 2010, while 1-to-4 family residential loans decreased \$8.1 million and construction loans decreased \$5.6 million over the same time period. The Bank's loans are made primarily to customers located within the Bank's primary market area. The Bank continually modifies its loan pricing strategies and expands its loan product offerings in an effort to increase lending activity without sacrificing the existing credit quality standards.

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## MATURITIES AND SENSITIVITIES OF LOANS TO CHANGES IN INTEREST RATES

The following is a schedule of maturities and sensitivities of loans subject to changes in interest rates as of December 31, 2010:

MATURITY SCHEDULE OF SELECTED LOANS  
(In Thousands)

|                                    | Within 1<br>Year | 1 Year<br>Within 5<br>Years | After 5<br>Years | Total     |
|------------------------------------|------------------|-----------------------------|------------------|-----------|
| Commercial real estate loans       | \$10,982         | \$83,578                    | \$120,789        | \$215,349 |
| Commercial and industrial loans    | 20,833           | 6,329                       | 2,657            | 29,819    |
| Construction loans                 | 15,005           | 10,173                      | 2,212            | 27,390    |
|                                    | \$46,820         | \$100,080                   | \$125,658        | \$272,558 |
| For maturities over one year:      |                  |                             |                  |           |
| Floating and adjustable rate loans |                  | \$21,078                    | \$53,198         | \$74,276  |
| Fixed rate loans                   |                  | 79,002                      | 72,460           | 151,462   |
|                                    |                  | \$100,080                   | \$125,658        | \$225,738 |

DEPOSITS. For the year ended December 31, 2010, total deposits increased by \$54.1 million or 11.6% when compared with total deposits one year earlier. Non-interest-bearing deposits decreased by \$845,000 and interest-bearing deposits increased by \$54.9 million. Between July 2009 and January 2010, the Bank opened two new branch offices and relocated one existing branch office. The new branches and the branch relocation were instrumental in the increase of deposits during 2010.

Included in interest-bearing deposits at December 31, 2010 were \$39.3 million of brokered deposits, or 7.6% of total deposits. This compares with \$57.3 million of brokered deposits at December 31, 2009, or 12.3% of total deposits. Of the \$39.3 million in brokered deposits at December 31, 2010, \$28.0 million were deposits of Bank customers, exchanged through the CD Account Registry Services' ("CDARS") network. Of the \$57.3 million in brokered deposits at December 31, 2009, \$31.1 million were deposits of Bank customers, exchanged through the CDARS network. With the CDARS program, funds are placed into certificate of deposits issued by other banks in the network, in increments usually less than \$100,000, 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 Bank projects to increase its transaction account and other deposits in 2011 and beyond through the expansion of its branch network, as well as by offering value-added NOW and demand deposit products, and selective rate premiums on its interest-bearing deposits.

The average daily amounts of deposits and rates paid on deposits is summarized for the periods indicated in the following table:

DEPOSITS AND RATES PAID  
(Dollars In Thousands)

| 2010   |      | Year ended December 31,<br>2009 |      | 2008   |      |
|--------|------|---------------------------------|------|--------|------|
| Amount | Rate | Amount                          | Rate | Amount | Rate |

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|                          |           |      |   |           |      |   |           |      |   |
|--------------------------|-----------|------|---|-----------|------|---|-----------|------|---|
| Non-interest-bearing     | \$67,386  |      |   | \$64,098  |      |   | \$67,541  |      |   |
| <b>Interest-bearing:</b> |           |      |   |           |      |   |           |      |   |
| NOW accounts             | 120,212   | 0.56 | % | 78,547    | 0.46 | % | 84,294    | 0.95 | % |
| Money market accounts    | 64,330    | 0.69 | % | 66,146    | 0.81 | % | 90,184    | 2.03 | % |
| Regular savings accounts | 50,481    | 0.41 | % | 38,190    | 0.37 | % | 31,482    | 0.47 | % |
| Time deposits:           | 192,920   | 1.92 | % | 179,204   | 2.55 | % | 123,424   | 3.67 | % |
| Total interest-bearing   | 427,943   | 1.18 | % | 362,087   | 1.55 | % | 329,384   | 2.22 | % |
| Total deposits           | \$495,329 |      |   | \$426,185 |      |   | \$396,925 |      |   |

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## MATURITY OF TIME DEPOSITS OF \$100,000 OR MORE

The following is a schedule of maturities of time deposits in amounts of \$100,000 or more at December 31, 2010:

MATURITIES OF CERTIFICATES OF DEPOSIT  
AND OTHER TIME DEPOSITS OF \$100,000 AND MORE

(In Thousands)  
At December 31, 2010

|                        | Within<br>Three<br>Months | Three to<br>Six Months | Six to<br>Twelve<br>Months | One to<br>Four Years | Over Four<br>Years | Total     |
|------------------------|---------------------------|------------------------|----------------------------|----------------------|--------------------|-----------|
| \$100,000 to \$250,000 | \$18,311                  | \$4,701                | \$13,679                   | \$27,270             | \$6,673            | \$70,634  |
| Over \$250,000         | 3,702                     | 790                    | 3,368                      | 12,378               | 9,709              | 29,947    |
| Total                  | \$22,013                  | \$5,491                | \$17,047                   | \$39,648             | \$16,382           | \$100,581 |

**BORROWINGS.** Amounts and weighted average rates for long and short term borrowings as of December 31, 2010, 2009 and 2008 are as follows:

BORROWED FUNDS  
(Dollars In Thousands)

|                         | December 31, 2010 |        | December 31, 2009 |        | December 31, 2008 |        |
|-------------------------|-------------------|--------|-------------------|--------|-------------------|--------|
|                         | Amount            | Rate   | Amount            | Rate   | Amount            | Rate   |
| FHLB advances           | \$25,000          | 3.91 % | \$50,000          | 2.19 % | \$45,000          | 3.35 % |
| Federal funds purchased | \$-               |        | \$-               |        | \$18,275          | 1.05 % |

At December 31, 2010, the weighted average life of the borrowed funds portfolio was 2.9 years.

## CAPITAL RESOURCES AND LIQUIDITY

Shareholders' equity totaled \$44.1 million at December 31, 2010 compared with \$42.6 million at December 31, 2009. The amount of equity reflects management's desire to increase shareholders' return on equity while maintaining a strong capital base. The Company initiated an open market stock buyback program in 1998, through which it repurchased 9,301 shares at a cost of \$155,000 in 2008, and no shares in 2009 and 2010.

Accumulated other comprehensive income/(loss) increased to an unrealized loss net of tax benefit of \$2.06 million at December 31, 2010, compared with \$1.92 million at December 31, 2009 and an unrealized loss net of tax benefit of \$2.22 million at December 31, 2008. The change in the accumulated other comprehensive loss between 2009 and 2008 was attributable to the increase of the ASC 715 "Compensation – Retirement Benefits" (formerly SFAS No. 158, "Employers' Accounting for Defined Benefit and Other Postretirement Plans,") impact regarding the Bank's defined benefit retirement and post-retirement plans. During 2009, the impact of the authoritative accounting guidance was a gain of \$263,000 net of tax benefit compared with a loss of \$167,000 net of tax benefit during 2008. See Note 2 "Securities" of the Notes to Consolidated Financial Statements for further discussion on the market value loss on the Bank's investment in pooled trust preferred securities.

During 2002 and 2006, the Company established subsidiary trusts that issued \$4.0 million and \$4.0 million of capital securities, respectively, as part of two separate pooled trust preferred security offerings with other financial institutions. During 2008, the Company repaid the \$4.0 million issued in 2002. 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 "Government Supervision and Regulation" in Part I, Item 1 of this Form 10-K, banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios. As of December 31, 2010, the appropriate regulatory authorities have categorized the Company and the Bank as "well capitalized."

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

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled \$47.2 million at December 31, 2010 compared with \$26.2 million at December 31, 2009. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available for sale, of which approximately \$3.3 million was unpledged and readily salable at December 31, 2010. In addition, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately \$118.7 million at December 31, 2010 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with various commercial banks, including the Federal Reserve, totaling approximately \$59.2 million. At December 31, 2010, \$25.0 million of the FHLB of Atlanta line of credit and none of federal funds purchased lines of credit were in use.

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

**LIQUIDITY SOURCES AND USES**  
(Dollars In Thousands)

|   | December 31, 2010 |        |                  | December 31, 2009 |        |                  |
|---|-------------------|--------|------------------|-------------------|--------|------------------|
|   | Total             | In Use | Available        | Total             | In Use | Available        |
| <b>Sources:</b>   |                   |        |                  |                   |        |                  |
| Federal funds borrowing lines of credit   | \$59,157          | \$-    | \$59,157         | \$72,563          | \$-    | \$72,563         |
| Federal Home Loan Bank lines of credit  | 118,655           | 25,000 | 93,655           | 108,310           | 50,000 | 58,310           |
| Federal funds sold and interest-bearing deposits in other banks, excluding reserve requirements | 26,339            |        | 26,339           | 13,617            |        | 13,617           |
| Securities, available for sale and unpledged at fair value                                      |                   |        | 3,297            |                   |        | 10,730           |
| <b>Total short-term funding sources</b>   |                   |        | <b>\$182,448</b> |                   |        | <b>\$155,220</b> |
| <b>Uses:</b>  |                   |        |                  |                   |        |                  |
|   |                   |        | \$62,798         |                   |        | \$71,523         |

|  |          |   |          |   |
|--|----------|---|----------|---|
| Unfunded loan commitments and lending lines of credit                    |          |   |          |   |
| Letters of credit  | 4,412    |   | 8,585    |   |
| Total potential short-term funding uses                                  | \$67,210 |   | \$80,108 |   |
| Ratio of short-term funding sources to potential short-term funding uses | 271.5    | % | 193.8    | % |

## CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and discretionary actions by regulators that could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of December 31, 2010, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

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

**REGULATORY CAPITAL RATIOS**  
(Dollars In Thousands)

|   | December 31,     |                  |
|---|------------------|------------------|
|   | 2010             | 2009             |
| <b>Tier 1 Capital:</b>  |                  |                  |
| Shareholders' Equity  | \$44,106         | \$42,639         |
| Plus: Unrealized loss on securities available for sale/FAS 158, net | 2,064            | 1,923            |
| Less: Unrealized loss on equity securities, net securities, net     | -                | (4 )             |
| Plus: Company-obligated mandatorily redeemable capital securities   | 4,000            | 4,000            |
| <b>Total Tier 1 Capital</b>   | <b>\$50,170</b>  | <b>48,558</b>    |
| <b>Tier 2 Capital:</b>  |                  |                  |
| Allowable Allowance for Loan Losses                                 | 5,558            | 5,482            |
| <b>Total Capital:</b>   | <b>55,728</b>    | <b>54,040</b>    |
| <b>Risk Weighted Assets:</b>  | <b>\$443,923</b> | <b>\$442,658</b> |
| <b>Leverage Ratio</b>   | <b>8.55</b>      | <b>% 8.68</b>    |
| <b>Risk Based Capital Ratios:</b>                                   |                  |                  |
| <b>Tier 1 to Risk Weighted Assets</b>                               | <b>11.30</b>     | <b>% 10.97</b>   |
| <b>Total Capital to Risk Weighted Assets</b>                        | <b>12.55</b>     | <b>% 12.21</b>   |

**CONTRACTUAL OBLIGATIONS**

The following table sets forth information relating to the Company's contractual obligations and scheduled payment amounts due at various intervals over the next five years and beyond as of December 31, 2010.

| (In Thousands)              | Total           | Payments due by period |                 |                 |                      |
|-----------------------------|-----------------|------------------------|-----------------|-----------------|----------------------|
|                             |                 | Less than<br>One Year  | 2-3 Years       | 4-5 Years       | More than<br>5 Years |
| Contractual Obligations:    |                 |                        |                 |                 |                      |
| Debt obligations            | \$29,124        | \$-                    | \$15,000        | \$10,000        | \$4,124              |
| Operating lease obligations | \$17,379        | 2,006                  | 3,994           | 3,495           | 7,884                |
| <b>Total</b>                | <b>\$46,503</b> | <b>\$2,006</b>         | <b>\$18,994</b> | <b>\$13,495</b> | <b>\$12,008</b>      |

\* Includes \$4.1 million of capital securities with varying put provisions beginning September 21, 2011 with a mandatory redemption September 21, 2036.



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### OFF-BALANCE SHEET ARRANGEMENTS

The Bank's off-balance sheet arrangements consist of interest rate swap agreements, commitments to extend credit and letters of credit.

The Company entered into an interest rate swap agreement on July 1, 2010. The Bank uses the interest rate swap to reduce interest rate risks and to manage interest income, specifically with regard to the interest rate expense on its Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. By entering into this agreement, the Company converts a floating rate liability priced at three month LIBOR plus 1.70% into a fixed rate liability priced at 4.91% through 2020. Interest differentials paid or received under the swap agreements are reflected as adjustments to interest income. These interest rate swap agreements are considered cash flow 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.

Commitments to extend credit and letters of credit were and \$62.80 million and \$4.4 million, respectively, at December 31, 2010, and \$71.5 million and \$8.6 million, respectively, at December 31, 2009.

See Note 16 "Financial Instruments with Off-Balance-Sheet Risk" and Note 17 "Derivative Instruments and Hedging Activities" of the Notes to Consolidated Financial Statements for further discussion on the specific arrangements and elements of credit and interest rate risk inherent to the arrangements. The impact on liquidity of these arrangements is illustrated in the LIQUIDITY SOURCES AND USES table above.

Revenues for standby letters of credit were \$63,000 and \$45,000 for 2010 and 2009, respectively. There were 46 and 61 separate standby letters of credit at December 31, 2010 and 2009, respectively. During 2010 and 2009, no liabilities arose from standby letters of credit arrangements. Past history gives little indication as to future trends regarding revenues and liabilities from standby letters of credit.

### IMPACT OF INFLATION AND CHANGING PRICES

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

### RECENT ACCOUNTING PRONOUNCEMENTS

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 7A. 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.

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The earnings simulation model forecasts annual net income under a variety of scenarios that incorporate changes in the absolute level of interest rates, changes in the shape of the yield curve, and changes in interest rate relationships. Management evaluates the effect on net interest income and present value equity under varying market rate assumptions. The Bank monitors exposure to instantaneous changes in rates of up to 200 basis points up or down over a rolling 12-month period. The Bank's policy limit for the maximum negative impact on net interest income and change in equity from instantaneous changes in interest rates of 200 basis points over 12 months is 15% and 20%, respectively. Management has maintained a risk position well within these guideline levels during 2010.

The following tables present the Bank's anticipated market value changes in equity under various rate scenarios as of December 31, 2010 and 2009:

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## MARKET RISK

| 2010                               | Percentage | Market  | Minus   | Current    | Plus       | Market       | Percentage |
|------------------------------------|------------|---|---------|------------|------------|--------------|------------|
| (Dollars In Thousands)             | Change     | Value Change  | 200 pts | Fair Value | 200 pts    | Value Change | Change     |
| Interest earning deposits in banks |            |   |         | \$ 41,919  | 41,919     | -            | 0.00 %     |
| Fed funds sold                     |            |   |         | 11         | 11         | -            | 0.00 %     |
| Securities                         |            | Note:   |         | 49,926     | 46,466     | (3,460 )     | -6.93 %    |
| Loans receivable                   |            | Due to the absolute level of  |         | 479,009    | 464,895    | (14,114 )    | -2.95 %    |
| Total rate sensitive assets        |            | market interest rates at December 31, 2010,                         |         | 570,865    | 553,291    | (17,574 )    | -3.08 %    |
| Other assets                       |            | the calculation of a change in market value due to an               |         | 40,490     | 40,490     | -            | 0.00 %     |
| Total assets                       |            | instantaneous decrease of 200 basis points would not be meaningful. |         | \$ 611,355 | \$ 593,781 | \$ (17,574 ) | -2.87 %    |
| Demand deposits                    |            |   |         | \$ 62,886  | \$ 59,547  | \$ (3,339 )  | -5.31 %    |
| Rate-bearing deposits              |            |   |         | 451,420    | 440,853    | (10,567 )    | -2.34 %    |
| Borrowed funds                     |            |   |         | 30,942     | 29,352     | (1,590 )     | -5.14 %    |
| Other liabilities                  |            |   |         | 4,754      | 4,754      | -            | 0.00 %     |
| Total liabilities                  |            |   |         | 550,002    | 534,506    | (15,496 )    | -2.82 %    |
| Present Value Equity               |            |   |         | 61,353     | 59,275     | (2,078 )     | -3.39 %    |
| Total liabilities and equity       |            |   |         | \$ 611,355 | \$ 593,781 | \$ (17,574 ) | -2.87 %    |

| 2009                               | Percentage | Market                       | Minus   | Current    | Plus    | Market       | Percentage |
|------------------------------------|------------|------------------------------|---------|------------|---------|--------------|------------|
| (Dollars In Thousands)             | Change     | Value Change                 | 200 pts | Fair Value | 200 pts | Value Change | Change     |
| Interest earning deposits in banks |            |                              |         | \$ 20,547  | 20,547  | -            | 0.00 %     |
| Fed funds sold                     |            |                              |         | 9          | 9       | -            | 0.00 %     |
| Securities                         |            | Note:                        |         | 40,467     | 38,764  | (1,703 )     | -4.21 %    |
| Loans receivable                   |            | Due to the absolute level of |         | 477,100    | 451,811 | (25,289 )    | -5.30 %    |

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|                              |   |            |            |              |        |   |
|------------------------------|---|------------|------------|--------------|--------|---|
| Total rate sensitive assets  | market interest rates   | 538,123    | 511,131    | (26,992 )    | -5.02  | % |
| Other assets                 | at December 31, 2009,   | 44,675     | 44,675     | -            | 0.00   | % |
| Total assets                 | the calculation of a change in market value due to an instantaneous decrease of 200 basis points would not be meaningful. | \$ 582,798 | \$ 555,806 | \$ (26,992 ) | -4.63  | % |
| Demand deposits              |   | \$ 62,361  | \$ 56,386  | \$ (5,975 )  | -9.58  | % |
| Rate-bearing deposits        |   | 397,280    | 388,793    | (8,487 )     | -2.14  | % |
| Borrowed funds               |   | 53,150     | 51,524     | (1,626 )     | -3.06  | % |
| Other liabilities            |   | 5,733      | 5,733      | -            | 0.00   | % |
| Total liabilities            |   | 518,524    | 502,436    | (16,088 )    | -3.10  | % |
| Present Value Equity         |   | 64,274     | 53,370     | (10,904 )    | -16.96 | % |
| Total liabilities and equity |   | \$ 582,798 | \$ 555,806 | \$ (26,992 ) | -4.63  | % |

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ITEM FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

8.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

FAUQUIER BANKSHARES, INC. AND SUBSIDIARIES

Warrenton, Virginia

CONSOLIDATED FINANCIAL REPORT

DECEMBER 31, 2010

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CONSOLIDATED FINANCIAL STATEMENTS

Consolidated balance sheets

Consolidated statements of income

Consolidated statements of cash flows

Consolidated statements of changes in shareholders' equity

Notes to consolidated financial statements

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of  
Fauquier Bankshares, Inc.  
Warrenton, Virginia

We have audited the accompanying consolidated balance sheets of Fauquier Bankshares, Inc. and its subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2010. The management of Fauquier Bankshares, Inc. and its subsidiaries (the "Company") is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Fauquier Bankshares, Inc. and its subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America.

/s/Smith Elliott Kearns & Company, LLC  
SMITH ELLIOTT KEARNS & COMPANY, LLC

Chambersburg, Pennsylvania  
March 11, 2011

Table of ContentsFauquier Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

|  | December 31,<br>2010 | December 31,<br>2009 |
|--|----------------------|----------------------|
| Assets   |                      |                      |
| Cash and due from banks  | \$5,252,361          | \$5,652,617          |
| Interest-bearing deposits in other banks   | 41,919,040           | 20,546,596           |
| Federal funds sold   | 11,098               | 9,154                |
| Securities available for sale, net   | 46,537,941           | 36,692,094           |
| Restricted investments   | 3,388,300            | 3,774,700            |
| Loans  | 466,748,799          | 468,265,925          |
| Less: Allowance for loan losses  | (6,307,193 )         | (5,481,963 )         |
| Net loans  | 460,441,606          | 462,783,962          |
| Bank premises and equipment, net   | 14,158,374           | 14,025,745           |
| Accrued interest receivable  | 1,488,438            | 1,495,085            |
| Other real estate owned, net of allowance  | 2,821,000            | 2,479,860            |
| Other assets   | 22,022,186           | 21,022,655           |
| Total assets   | \$598,040,344        | \$568,482,468        |
| Liabilities and Shareholders' Equity   |                      |                      |
| Deposits:  |                      |                      |
| Noninterest-bearing  | \$67,624,847         | \$68,469,699         |
| Interest-bearing:  |                      |                      |
| NOW accounts   | 143,842,999          | 83,395,687           |
| Savings and money market accounts  | 132,825,735          | 106,458,563          |
| Time deposits  | 175,762,789          | 207,662,808          |
| Total interest-bearing   | 452,431,523          | 397,517,058          |
| Total deposits   | 520,056,370          | 465,986,757          |
| Federal funds purchased  | -                    | -                    |
| Federal Home Loan Bank advances  | 25,000,000           | 50,000,000           |
| Company-obligated mandatorily redeemable capital securities  | 4,124,000            | 4,124,000            |
| Other liabilities  | 4,754,411            | 5,732,869            |
| Commitments and Contingencies  | -                    | -                    |
| Total liabilities  | 553,934,781          | 525,843,626          |
| Shareholders' Equity   |                      |                      |
| Common stock, par value, \$3.13; authorized 8,000,000 shares: issued and outstanding, 2010: 3,636,758 shares (includes nonvested shares of 33,772); 2009: 3,594,685 shares (includes nonvested shares of 47,282) | 11,277,346           | 11,103,371           |
| Retained earnings  | 34,892,905           | 33,458,933           |
| Accumulated other comprehensive income (loss), net   | (2,064,688 )         | (1,923,462 )         |
| Total shareholders' equity   | 44,105,563           | 42,638,842           |
| Total liabilities and shareholders' equity   | \$598,040,344        | \$568,482,468        |

See accompanying Notes to Consolidated Financial Statements.





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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
For Each of the Three Years in the Period Ended December 31, 2010

|  | 2010         | 2009         | 2008         |
|--|--------------|--------------|--------------|
| <b>Interest Income</b>   |              |              |              |
| Interest and fees on loans   | \$26,848,854 | \$26,472,658 | \$26,943,526 |
| Interest and dividends on securities available for sale:                             |              |              |              |
| Taxable interest income  | 1,133,531    | 1,278,251    | 1,410,216    |
| Interest income exempt from federal income taxes                                     | 228,598      | 238,025      | 234,791      |
| Dividends  | 46,176       | 65,298       | 180,835      |
| Interest on federal funds sold   | 21           | 201          | 33,303       |
| Interest on deposits in other banks  | 73,293       | 19,573       | 35,753       |
| Total interest income  | 28,330,473   | 28,074,006   | 28,838,424   |
| <b>Interest Expense</b>  |              |              |              |
| Interest on deposits   | 5,035,625    | 5,598,144    | 7,301,118    |
| Interest on federal funds purchased  | 1,330        | 41,341       | 117,719      |
| Interest on Federal Home Loan Bank advances  | 969,815      | 1,050,444    | 1,768,597    |
| Distribution on capital securities of subsidiary trusts                              | 117,316      | 109,051      | 200,263      |
| Total interest expense   | 6,124,086    | 6,798,980    | 9,387,697    |
| Net interest income  | 22,206,387   | 21,275,026   | 19,450,727   |
| Provision for loan losses  | 2,075,000    | 1,710,000    | 3,227,269    |
| Net interest income after provision for loan losses                                  | 20,131,387   | 19,565,026   | 16,223,458   |
| <b>Other Income</b>  |              |              |              |
| Trust and estate income  | 1,059,573    | 898,927      | 1,039,876    |
| Brokerage income   | 393,826      | 214,381      | 246,695      |
| Service charges on deposit accounts  | 2,799,489    | 2,710,499    | 2,776,599    |
| Other service charges, commissions and income  | 1,434,675    | 1,464,750    | 1,839,155    |
| Gain (loss) on sale and impairment of other real estate owned                        | (119,810 )   | (135,759 )   | 25,718       |
| Total other-than temporary impairment losses on securities                           | (1,370,032 ) | (1,225,641 ) | (422,500 )   |
| Less: Portion of gain (loss) recognized in other comprehensive income (before taxes) | (33,521 )    | 454,007      | -            |
| Net other-than temporary impairment losses on securities                             | (1,403,553 ) | (771,634 )   | (422,500 )   |
| Gain on sale of securities   | 541,109      | -            | 87,585       |
| Total other income   | 4,705,309    | 4,381,164    | 5,593,128    |
| <b>Other Expenses</b>  |              |              |              |
| Salaries and benefits  | 10,541,346   | 9,871,987    | 8,266,366    |
| Net occupancy expense of premises  | 1,814,909    | 1,444,687    | 1,286,499    |
| Furniture and equipment  | 1,251,277    | 1,099,171    | 1,176,410    |
| Marketing expense  | 675,227      | 707,160      | 619,908      |
| Legal, audit and consulting expense  | 1,028,635    | 1,287,152    | 1,095,359    |
| Data processing expense  | 1,040,233    | 1,050,859    | 1,268,929    |
| Federal Deposit Insurance Corporation expense  | 733,989      | 865,861      | 290,922      |

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|                                       |             |             |             |
|---------------------------------------|-------------|-------------|-------------|
| Other operating expenses              | 2,990,850   | 3,045,894   | 2,793,829   |
| Total other expenses                  | 20,076,466  | 19,372,771  | 16,798,222  |
| Income before income taxes            | 4,760,230   | 4,573,419   | 5,018,364   |
| Income tax expense                    | 1,092,914   | 1,155,941   | 1,365,649   |
| Net Income                            | \$3,667,316 | \$3,417,478 | \$3,652,715 |
| Earnings per Share, basic             | \$1.01      | \$0.95      | \$1.04      |
| Earnings per Share, assuming dilution | \$1.01      | \$0.95      | \$1.03      |
| Dividends per Share                   | \$0.72      | \$0.80      | \$0.80      |

See accompanying Notes to Consolidated Financial Statements.

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
For Each of the Three Years in the Period Ended December 31, 2010

|   | 2010         | 2009          | 2008         |
|---|--------------|---------------|--------------|
| <b>Cash Flows from Operating Activities</b>   |              |               |              |
| Net income  | \$3,667,316  | \$3,417,478   | \$3,652,715  |
| Adjustments to reconcile net income to net cash provided by operating activities:       |              |               |              |
| Depreciation and amortization   | 1,234,425    | 808,312       | 909,992      |
| Loss on disposal of fixed assets  | 140,067      | -             | -            |
| Provision for loan losses   | 2,075,000    | 1,710,000     | 3,227,269    |
| Deferred tax benefit  | (854,412 )   | (874,440 )    | (661,835 )   |
| Loss on impairment of other real estate   | 58,085       | -             | -            |
| Loss (gain) on sale of other real estate owned  | 61,725       | 135,759       | (25,718 )    |
| Loss on impairment of securities  | 1,403,553    | 771,634       | 422,500      |
| (Gain) on sale of securities  | (541,109 )   | -             | (87,585 )    |
| Tax benefit of nonqualified options exercised   | (54,832 )    | (10,162 )     | (21,783 )    |
| Amortization (accretion) of security premiums, net                                      | 71,748       | (19,698 )     | (5,483 )     |
| Amortization of unearned compensation, net  | 246,789      | 208,666       | 263,575      |
| Changes in assets and liabilities:  |              |               |              |
| (Increase) in other assets  | (47,042 )    | (2,518,912 )  | (793,455 )   |
| Increase (decrease) in other liabilities  | (313,656 )   | 398,205       | 262,836      |
| Net cash provided by operating activities   | 7,147,657    | 4,026,842     | 7,143,028    |
| <b>Cash Flows from Investing Activities</b>   |              |               |              |
| Proceeds from sale of securities available for sale                                     | 10,487,508   | -             | 9,078,470    |
| Proceeds from maturities, calls and principal payments of securities available for sale | 14,707,585   | 9,145,417     | 4,843,106    |
| Purchase of securities available for sale   | (36,817,758) | (11,757,480 ) | (16,253,706) |
| Purchase of premises and equipment  | (1,507,121 ) | (6,212,840 )  | (2,350,840 ) |
| (Purchase of) proceeds from redemption of other bank stock                              | 386,400      | (719,900 )    | (392,300 )   |
| Net (increase) in loans   | (1,010,644 ) | (29,815,529 ) | (32,517,055) |
| Proceeds from sale of other real estate owned   | 817,050      | 869,626       | 710,083      |
| Net cash (used in) investing activities   | (12,936,980) | (38,490,706 ) | (36,882,242) |
| <b>Cash Flows from Financing Activities</b>   |              |               |              |
| Net (decrease) increase in demand deposits, NOW accounts and savings accounts           | 85,969,632   | 11,891,346    | (47,290,885) |
| Net (decrease) increase in certificates of deposit                                      | (31,900,019) | 53,801,780    | 43,025,593   |
| Federal Home Loan Bank advances   | -            | 170,000,000   | 75,000,000   |
| Federal Home Loan Bank principal repayments   | (25,000,000) | (165,000,000) | (65,000,000) |
| Purchase (repayment) of federal funds   | -            | (18,275,000 ) | 18,275,000   |
| Cash dividends paid on common stock   | (2,615,023 ) | (2,877,259 )  | (2,853,779 ) |
| Issuance of common stock  | 308,865      | 108,202       | 209,304      |
| Acquisition of common stock   | -            | -             | (155,031 )   |
| Net cash provided by financing activities   | 26,763,455   | 49,649,069    | 21,210,202   |
| Increase (decrease) in cash and cash equivalents  | 20,974,132   | 15,185,205    | (8,529,012 ) |

## Cash and Cash Equivalents

|           |            |            |            |
|-----------|------------|------------|------------|
| Beginning | 26,208,367 | 11,023,162 | 19,552,174 |
|-----------|------------|------------|------------|

|        |              |              |              |
|--------|--------------|--------------|--------------|
| Ending | \$47,182,499 | \$26,208,367 | \$11,023,162 |
|--------|--------------|--------------|--------------|

## Supplemental Disclosures of Cash Flow Information

## Cash payments for:

|          |             |             |             |
|----------|-------------|-------------|-------------|
| Interest | \$6,272,878 | \$7,048,637 | \$9,447,980 |
|----------|-------------|-------------|-------------|

|              |             |             |             |
|--------------|-------------|-------------|-------------|
| Income taxes | \$2,376,000 | \$1,729,000 | \$1,774,500 |
|--------------|-------------|-------------|-------------|

## Supplemental Disclosures of Noncash Investing Activities

|   |             |           |             |
|---|-------------|-----------|-------------|
| Foreclosed assets acquired in settlement of loans | \$1,278,000 | \$450,775 | \$3,718,835 |
|---|-------------|-----------|-------------|

|  |              |          |                |
|--|--------------|----------|----------------|
| Unrealized gain (loss) on securities available for sale, net of tax effect | \$(556,131 ) | \$31,279 | \$(1,276,886 ) |
|--|--------------|----------|----------------|

|   |           |           |              |
|---|-----------|-----------|--------------|
| Changes in benefit obligations and plan assets for defined benefit and post-retirement benefit plans, net of tax effect | \$402,579 | \$262,800 | \$(167,226 ) |
|---|-----------|-----------|--------------|

See accompanying Notes to Consolidated Financial Statements.

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Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Changes in Shareholders' Equity  
For Each of the Three Years Ended December 31, 2010

|   | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Comprehensive<br>Income | Total         |
|---|-----------------|----------------------|--|-------------------------|---------------|
| Balance, December 31, 2007  | \$ 10,974,293   | \$ 31,626,627        | \$ (773,168 )  |                         | \$ 41,827,752 |
| Comprehensive income:   |                 |                      |  |                         |               |
| Net income  | -               | 3,652,715            | -  | \$ 3,652,715            | 3,652,715     |
| Other comprehensive income net of tax:  |                 |                      |  |                         |               |
| Unrealized holding losses on securities available for sale, net of deferred tax benefit of \$771,661              |                 |                      | (1,497,930 )   | (1,497,930 )            |               |
| Add: reclassification adjustments, net of tax of \$113,871  |                 |                      | 221,044  | 221,044                 |               |
| Less: change in beneficial obligation for defined benefit and SERP plans, net of deferred tax benefit of \$86,147 |                 |                      | (167,226 )   | (167,226 )              |               |
| Other comprehensive income net of tax benefit of \$743,937  |                 |                      |  | (1,444,112 )            | (1,444,112 )  |
| Total comprehensive income  |                 |                      |  | \$ 2,208,603            |               |
| Initial implementation of EITF 06-4, net of income tax benefit of \$6,433   | -               | (12,487 )            | -  |                         | (12,487 )     |
| Cash dividends (\$.80 per share)  | -               | (2,853,779 )         | -  |                         | (2,853,779 )  |
| Acquisition of 9,301 shares of common stock   | (29,112 )       | (125,919 )           | -  |                         | (155,031 )    |
| Amortization of unearned compensation, restricted stock awards  | -               | 289,820              | -  |                         | 289,820       |
| Restricted stock forfeiture   | -               | (49,604 )            | -  |                         | (49,604 )     |
| Issuance of common stock - nonvested shares (10,315 shares)   | 32,286          | (32,286 )            | -  |                         | -             |
| Exercise of stock options   | 59,220          | 173,443              | -  |                         | 232,663       |
| Balance, December 31, 2008  | \$ 11,036,687   | \$ 32,668,530        | \$ (2,217,280 )  |                         | \$ 41,487,937 |
| Comprehensive income:   |                 |                      |  |                         |               |
| Net income  | -               | 3,417,478            | -  | \$ 3,417,478            | 3,417,478     |
| Other comprehensive income net of tax:  |                 |                      |  |                         |               |
| Unrealized holding losses on securities available for sale, net of deferred tax benefit of \$246,422              |                 |                      | (477,999 )   | (477,999 )              |               |
| Add: reclassification adjustments, net of tax of \$262,356  |                 |                      | 509,278  | 509,278                 |               |
| Add: change in beneficial obligation for defined benefit and  |                 |                      |  |                         |               |

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|  |               |               |                 |  |               |
|--|---------------|---------------|-----------------|--|---------------|
| SERP plans, net of deferred tax of \$135,246                   |               |               | 262,539         |  | 262,539       |
| Other comprehensive income net of tax of \$151,180             |               |               |                 |  | 293,818       |
| Total comprehensive income                                     |               |               |                 |  | \$ 3,711,296  |
| Cash dividends (\$.80 per share)                               | -             | (2,877,259 )  | -               |  | (2,877,259 )  |
| Amortization of unearned compensation, restricted stock awards | -             | 208,666       | -               |  | 208,666       |
| Issuance of common stock - nonvested shares (10,585 shares)    | 33,131        | (33,131 )     | -               |  | -             |
| Exercise of stock options                                      | 33,553        | 74,649        | -               |  | 108,202       |
| Balance, December 31, 2009                                     | \$ 11,103,371 | \$ 33,458,933 | \$ (1,923,462 ) |  | \$ 42,638,843 |

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Fauquier Bankshares, Inc. and Subsidiaries  
 Consolidated Statements of Changes in Shareholders' Equity  
 For Each of the Three Years in the Period Ended December 31, 2010

|   | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Comprehensive<br>Income | Total         |
|---|-----------------|----------------------|--|-------------------------|---------------|
| Balance, December 31, 2009  | \$ 11,103,371   | \$ 33,458,932        | \$ (1,923,462 )  |                         | \$ 42,638,841 |
| Net income  | -               | 3,667,316            | -  | \$ 3,667,316            | 3,667,316     |
| Other comprehensive income net of tax:  |                 |                      |  |                         |               |
| Interest rate swap (cash flow hedge), net of tax benefit of \$6,350                                     |                 |                      | 12,326   | 12,326                  |               |
| Unrealized holding losses on securities available for sale, net of deferred tax benefit of \$579,725    |                 |                      | (1,125,344 )   | (1,125,344 )            |               |
| Add: change in beneficial obligation for defined benefit and SERP plans, net of tax of \$207,390        |                 |                      | 402,579  | 402,579                 |               |
| Less: gain on sale of securities available for sale, net of tax benefit of \$183,977                    |                 |                      | (357,132 )   | (357,132 )              |               |
| Add: reclassification adjustments for other than temporary impairment, net of deferred tax of \$477,208 |                 |                      | 926,345  | 926,345                 |               |
| Other comprehensive income (loss) net of tax of \$72,754  |                 |                      | (141,226 )   | (141,226 )              | (141,226 )    |
| Total comprehensive income  |                 |                      |  | \$ 3,526,090            |               |
| Cash dividends (\$.72 per share)  |                 | (2,615,023 )         | -  |                         | (2,615,023 )  |
| Amortization of unearned compensation, restricted stock awards  |                 | 246,789              | -  |                         | 246,789       |
| Issuance of common stock - nonvested shares (28,847 shares)   | 90,291          | (90,291 )            | -  |                         | -             |
| Issuance of common stock - vested shares (6,522 shares)   | 20,414          | 69,459               |  |                         | 89,873        |
| Exercise of stock options   | 63,270          | 155,722              | -  |                         | 218,992       |
| Balance, December 31, 2010  | \$ 11,277,346   | \$ 34,892,904        | \$ (2,064,688 )  |                         | \$ 44,105,562 |

See accompanying Notes to Consolidated Financial Statements.



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FAUQUIER BANKSHARES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

For Each of the Three Years in the Period Ended December 31, 2010

Note 1. Nature of Banking Activities and Significant Accounting Policies

Fauquier Bankshares, Inc. (“the Company”) is the holding company of The Fauquier Bank (“the Bank”), Fauquier Statutory Trust I (“Trust I”) and Fauquier Statutory Trust II (“Trust II”). The Bank provides commercial, financial, agricultural, and residential and consumer loans to customers primarily in Virginia. The loan portfolio is well diversified and generally is collateralized by assets of the customers. The loans are expected to be repaid from cash flows or proceeds from the sale of selected assets of the borrowers. The purpose of the September 2006 (Trust II) issuance was to use the proceeds to redeem the existing capital security (Trust I) issued on March 26, 2002.

The accounting and reporting policies of the Company conform to U.S. generally accepted accounting principles and to the reporting guidelines prescribed by regulatory authorities. The following is a description of the more significant of those policies and practices.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, and its three wholly-owned subsidiaries, Trust I, Trust II and the Bank, of which Fauquier Bank Services, Inc. is its sole subsidiary. In consolidation, significant intercompany accounts and transactions between the Bank and the Company have been eliminated.

Authoritative accounting guidance clarifies the rules for consolidation of certain entities in which voting rights are not effective in identifying the investor with the controlling financial interest. An entity is subject to deconsolidation under the guidance if the investors do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, are unable to direct the entity’s activities, or are not exposed to the entity’s losses or entitled to its residual returns (“variable interest entities”). Variable interest entities within the scope of the authoritative accounting guidance will be required to be consolidated with their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity’s losses, receives a majority of its expected returns, or both.

Management has determined that the Fauquier Statutory Trusts (Trust I and Trust II) qualify as variable interest entities. Trust I issued mandatory redeemable capital securities to investors and loaned the proceeds to the Company. Trust I held, as its sole asset, subordinated debentures issued by the Company in 2002. The deconsolidation results in the Company’s investment in the common securities of Trust I being included in other assets as of December 31, 2007 and a corresponding increase in outstanding debt of \$124,000. The revised authoritative accounting guidance did not have a material impact on the Company’s financial position or results of operations. Because the Company redeemed all the existing capital securities issued by Trust I on March 26, 2008, there were no assets in Trust I on December 31, 2008.

The Board of Governors of the Federal Reserve System (“Federal Reserve”) has issued guidance on the regulatory capital treatment for the trust-preferred securities issued by the Company as a result of the adoption of the authoritative accounting guidance. The rule retains the current maximum percentage of total capital permitted for trust preferred securities at 25%, but enacts other changes to the rules governing trust preferred securities that affect their use as part of the collection of entities known as “restricted core capital elements.” The rule took effect March 31, 2008. Management evaluated the effects of the rule, and determined that it did not have a material impact on its

capital ratios.

#### Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. The Company has no securities in this category. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

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### Notes to Consolidated Financial Statements

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Company intends to sell the security, whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, and whether the Company expects to recover the security's entire amortized cost basis. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Bank is required to maintain an investment in the capital stock of certain correspondent banks. No readily available market exists for this stock and it has no quoted market value. The investment in these securities is recorded at cost and they are reported on the Company's consolidated balance sheet as restricted securities.

### Loans

Loans are presented on the consolidated balance sheet at their recorded investment, which represents the unpaid principal balances, less the allowance for loan losses, partial charge-offs and the net of unamortized deferred loans fees and costs.

The Company grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by commercial and residential mortgage loans. The ability of the Company's debtors to honor their contracts is dependent upon the real estate and general economic conditions in the Company's market area. The Company does not have significant concentrations in any one industry or customer.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on mortgage, commercial and installment loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Loans are typically charged off no later than 180 days past due. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered uncollectable.

All interest accrued but not collected for loans that are placed on nonaccrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.



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Notes to Consolidated Financial Statements

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

All loans are risk rated by a universal bank grading system, (1-9), endorsed by federal agencies. Level 1 is a loan with minimal risk, 2-modest risk, 3-average risk, 4- acceptable risk, 5-marginally acceptable risk, 6-Other Assets Especially Mentioned, (potential weaknesses identified), 7- Substandard, (well defined weaknesses that may result in possible losses), 8-Doubtful, (unlikely to be repaid in full and will probably result in losses), 9- Loss, (will not be repaid in full and losses will occur).

The allowance consists of specific (ASC 310.10.35) and general (ASC 450.10) components. The specific component (ASC 310.10.35) relates to loans that are classified as impaired. For such loans, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component, (ASC 450.10), covers non-classified loans and is based on historical loss experience adjusted for qualitative factors and is also maintained to cover uncertainties that could affect management's estimate of probable losses. This 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. Individual portfolio segments are evaluated on a rolling quarterly basis for the six prior quarters through a rating matrix that values internal and external qualitative factors and within a range of performing allocations by the following categories: delinquency, short term and long term loss history, and non-performing loans,

Risk characteristics are evaluated for each portfolio segment by reviewing external factors such as: unemployment, new building permits, bankruptcies, foreclosures, regional economic conditions, competition and regulatory factors. Internal risk characteristics evaluated include: lender turnover, lender experience, lending policy changes, loan portfolio & terms, collateral, risk rating downgrades, loan concentrations, and loan review.

Commercial real estate loans are subject to being in a cyclical industry that has economic and collateral value fluctuations. Commercial real estate lending is primarily limited to our specific geographic market area of Fauquier and western Prince William counties. Generally, the Bank does not provide stand alone construction financing for the commercial or residential market. Construction lending normally results in permanent financing provided by the Bank. Commercial and industrial loans are made to small businesses in our geographic market area that are subject to management, industry and economic fluctuations that can impact cash flow, which is the primary source of repayment for both commercial and industrial loans and commercial real estate loans. Collateral for these loans is real estate and/or business assets, such as equipment and inventories. This collateral can fluctuate in value based on market conditions and timing of sale. Retail loans, which include residential mortgages, home equity lines of credit, and consumer loans, are made within strict loan policies, procedures, and regulatory compliance guidelines. These loans are regularly reviewed by independent third party consultants for compliance. Retail loans, when compared to commercial and industrial loans and commercial real estate loans, are of relatively smaller amounts made to many diverse customers within the Bank's specific market area. There is not a dominant industry within the Bank's defined market area, but due to the Bank's proximity to Washington, D.C., a significant amount of local employment is directly or indirectly related to the federal government.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer loans, residential loans, and home equity lines of credit loans for impairment disclosures.



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### Notes to Consolidated Financial Statements

Commercial and industrial loans, commercial real estate loans, and construction loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and industrial, commercial real estate, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

A Troubled Debt Restructuring ("TDR") identification process has been established using a template of questions that determine whether a debtor is experiencing financial difficulty and, if so, whether the bank has granted a concession to a borrower by modifying the loan. Then, mitigating factors are evaluated to determine a final conclusion as to whether the loan is a TDR.

One loan in the portfolio has been identified as a TDR. This loan, with a balance of \$255,000, is a commercial and industrial loan, secured by business assets. The loan was originated during December 2007 and was modified during June 2010. At December 31, 2010, this loan was not performing in accordance with its modified terms, and is on non-accrual status and an appropriate specific reserve has been established.

### Bank Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation and amortization. Premises and equipment are depreciated over their estimated useful lives ranging from 3 - 39 years; leasehold improvements are amortized over the lives of the respective leases or the estimated useful life of the leasehold improvement, whichever is less. Software is amortized over its estimated useful life ranging from 3 - 5 years. Depreciation and amortization are recorded on the accelerated and straight-line methods.

Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate.

### Income Taxes

Deferred income tax assets and liabilities are determined using the balance sheet method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not

recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.



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### Notes to Consolidated Financial Statements

Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the statement of income.

### Defined Benefit Pension Plan

Until December 31, 2010, the Company had a pension plan for its employees. Benefits were generally based upon years of service and the employees' compensation. The Company funded pension costs in accordance with the funding provisions of the Employee Retirement Income Security Act. The Company's defined benefit plan was terminated on December 31, 2009 and settled during December 2010.

### Earnings Per Share

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury method.

### Stock Compensation Plans

Stock compensation accounting guidance requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements, including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the price of the Company's common stock at the date of the grant is used for restricted awards. There were no options granted in 2010, 2009, or 2008.

### Wealth Management Services Division

Securities and other property held by the Wealth Management Services division in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

### Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, amounts due from banks, interest bearing deposits in banks and federal funds sold. Generally, federal funds are purchased and sold for one day periods.

### Other Real Estate

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of the loan balance or fair value, less cost to sell, at the date of foreclosure, establishing a new cost basis. Capitalized costs include accrued interest and any costs that significantly improve the value of the properties. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying

amount or fair value less cost to sell. Gains and losses resulting from the sale or write-down of foreclosed real estate are recorded in other income. Revenue and expenses from operations and changes in the valuation allowance are included in other operating expenses.

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## Notes to Consolidated Financial Statements

## Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the valuation of foreclosed real estate and deferred tax assets.

## Marketing

The Company follows the policy of charging the costs of marketing, including advertising, to expense as incurred. Marketing expenses of \$675,227, \$707,160, and \$619,908 were incurred in 2010, 2009 and 2008, respectively.

## Comprehensive Income

Under generally accepted accounting principles, comprehensive income is defined as the change in equity from transactions and other events from nonowner sources. It includes all changes in equity except those resulting from investments by shareholders and distributions to shareholders. Comprehensive income includes net income and certain elements of "other comprehensive income" such as foreign currency transactions; accounting for futures contracts; employers' accounting for pensions; and accounting for certain investments in debt and equity securities.

The Company has elected to report its comprehensive income in the statement of changes in shareholders' equity. The elements of "other comprehensive income" that the Company has are unrealized gains or losses on available for sale securities and the defined benefit pension obligation.

Accumulated other comprehensive income (loss) consists of the following components, net of deferred tax:

|                            | Unrealized<br>Gains (Losses)<br>on Securities | Defined<br>Benefit<br>Retirement<br>Obligation | Unrealized<br>Holding<br>Gains<br>(Losses) in<br>Fair Value of<br>Derivatives<br>Used for<br>Cash Flow<br>Hedge | Total          |
|----------------------------|---|--|---|----------------|
| Balance, December 31, 2008 | \$ (1,609,083)                                | \$ (608,197)                                   | \$ -  | \$ (2,217,280) |
| 2009 change                | 31,279  | 262,539  | -   | 293,818        |
| Balance, December 31, 2009 | (1,577,804)                                   | (345,658)                                      | -   | (1,923,462)    |
| 2010 change                | (556,131)                                     | 402,579  | 12,326  | (141,226)      |
| Balance, December 31, 2010 | \$ (2,133,935)                                | \$ 56,921                                      | \$ 12,326   | \$ (2,064,688) |

## Fair Value Measurements

Fair values of financial institutions are estimated using relevant information and assumptions, as more fully disclosed in Note 18. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

#### Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the asset has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets..

#### Reclassifications

Certain reclassifications have been made to prior period balances to conform to the current year presentation.

#### Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as Statement of Financial Accounting Standards (“SFAS”) No. 166, “Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140,” was adopted into the Accounting Standards Codification (“Codification”) in December 2009 through the issuance of Accounting Standards Update (“ASU”) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets. ASU 2009-16 was effective for transfers on or after January 1, 2010. The adoption of the new guidance did not have a material impact on the Company’s consolidated financial statements.

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Notes to Consolidated Financial Statements

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

In October 2009, the FASB issued ASU 2009-15, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing." ASU 2009-15 amends Subtopic 470-20 to expand accounting and reporting guidance for own-share lending arrangements issued in contemplation of convertible debt issuance. ASU 2009-15 is effective for fiscal years beginning on or after December 15, 2009 and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2010, the FASB issued ASU 2010-04, "Accounting for Various Topics – Technical Corrections to SEC Paragraphs". ASU 2010-04 makes technical corrections to existing Securities and Exchange Commission ("SEC") guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements - subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2010, the FASB issued ASU 2010-06, "Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements." ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In February 2010, the FASB issued ASU 2010-09, "Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements." ASU 2010-09 addresses both the interaction of the requirements of Topic 855 with the SEC's reporting requirements and the intended breadth of the reissuance disclosures provisions related to subsequent events. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. ASU 2010-09 was effective immediately. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

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



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Notes to Consolidated Financial Statements

On September 15, 2010, the SEC issued Release No. 33-9142, “Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Non-Accelerated Filers.” This release issued a final rule adopting amendments to its rules and forms to conform them to Section 404(c) of the Sarbanes-Oxley Act of 2002 (“SOX”), as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act. SOX Section 404(c) provides that Section 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934. Release No. 33-9142 was effective September 21, 2010. At December 31, 2010, the Company was neither accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934.

On September 17, 2010, the SEC issued Release No. 33-9144, “Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management’s Discussion and Analysis.” This interpretive release is intended to improve discussion of liquidity and capital resources in a public company’s Management’s Discussion and Analysis of Financial Condition and Results of Operations section in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant. This release was issued in conjunction with a proposed rule, “Short-Term Borrowings Disclosures,” that would require public companies to disclose additional information to investors about their short-term borrowing arrangements. Release No. 33-9144 was effective on September 28, 2010.

In January 2011, the FASB issued ASU 2011-01, “Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20.” The amendments in this ASU temporarily delay the effective date of the disclosures about troubled debt restructurings in ASU 2010-20 for public entities. The delay is intended to allow the FASB time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring will then be coordinated. Currently, that guidance is anticipated to be effective for interim and annual periods ending after June 15, 2011.

In December 2010, the FASB issued ASU 2010-29, “Disclosure of Supplementary Pro Forma Information for Business Combinations.” The guidance requires pro forma disclosure for business combinations that occurred in the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma information should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. ASU 2010-29 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The adoption of the new guidance is not expected to have a material impact on the Company’s consolidated financial statements.

In December 2010, the FASB issued ASU 2010-28, “When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts.” The amendments in this ASU modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. For public entities, the amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. The adoption of the new guidance is not expected to have a material impact on the Bank’s/Company’s (consolidated) financial statements.

For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Nonpublic entities may early adopt the amendments using the effective date for public entities. The adoption of the new guidance is not expected to have a material impact on the Company’s consolidated financial statements.





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## Notes to Consolidated Financial Statements

The SEC has issued Final Rule No. 33-9002, "Interactive Data to Improve Financial Reporting," which requires companies to submit financial statements in XBRL (extensible business reporting language) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using accounting principles generally accepted in the United States were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers are required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011.

## Note 2. Securities

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

|  | December 31, 2010 |            |                |               |
|--|-------------------|------------|----------------|---------------|
|  | Amortized         | Gross      | Gross          | Fair Value    |
|  | Cost              | Unrealized | Unrealized     |               |
|  |                   | Gains      | (Losses)       |               |
| Obligations of U.S.                              |                   |            |                |               |
| Government corporations and agencies             | \$ 40,020,633     | \$ 353,292 | \$ (342,206 )  | \$ 40,031,719 |
| Obligations of states and political subdivisions | 5,467,451         | 154,160    | (2,847 )       | 5,618,764     |
| Corporate Bonds                                  | 3,947,133         | -          | (3,395,289)    | 551,844       |
| Mutual Funds                                     | 326,861           | -          | (347 )         | 326,514       |
| FHLMC Preferred Bank Stock                       | 9,100             | -          | -              | 9,100         |
|  | \$ 49,771,178     | \$ 507,452 | \$ (3,740,689) | \$ 46,537,941 |

|  | December 31, 2009 |              |                |               |
|--|-------------------|--------------|----------------|---------------|
|  | Amortized         | Gross        | Gross          | Fair Value    |
|  | Cost              | Unrealized   | Unrealized     |               |
|  |                   | Gains        | (Losses)       |               |
| Obligations of U.S.                              |                   |              |                |               |
| Government corporations and agencies             | \$ 27,837,619     | \$ 916,798   | \$ (25,592 )   | \$ 28,728,825 |
| Obligations of states and political subdivisions | 5,569,586         | 163,021      | (8,758 )       | 5,723,849     |
| Corporate Bonds                                  | 5,341,286         | -            | (3,428,830)    | 1,912,456     |
| Mutual Funds                                     | 315,715           | -            | (3,451 )       | 312,264       |
| FHLMC Preferred Bank Stock                       | 18,500            | -            | (3,800 )       | 14,700        |
|  | \$ 39,082,706     | \$ 1,079,819 | \$ (3,470,431) | \$ 36,692,094 |

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

|                         | 2010      |       |
|-------------------------|-----------|-------|
|                         | Amortized | Fair  |
|                         | Cost      | Value |
| Due in one year or less | \$ -      | \$ -  |

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|  |               |               |
|--|---------------|---------------|
| Due after one year through five years  | 15,067,663    | 14,978,976    |
| Due after five years through ten years | 5,275,061     | 5,395,549     |
| Due after ten years                    | 29,092,493    | 25,827,802    |
| Equity securities                      | 335,961       | 335,614       |
|  | \$ 49,771,178 | \$ 46,537,941 |

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## Notes to Consolidated Financial Statements

During 2010, nine securities with a total amortized cost of \$9.9 million were sold at a gain of \$541,109. Eight of these bonds were sold in order to ensure the recognition of current value that had future exposure to prepayment risk, and one bond was sold due to its relatively longer-term contractual duration and inherent extension risk of an additional two years duration if market rates were to increase in the future. The tax expense on these gains on sale totaled \$183,977.

During 2010, the Company recognized an Other Than Temporary Impairment (“OTTI”) on its investment in pooled trust preferred securities of \$1,394,153 and on its Freddie Mac preferred stock of \$9,400. The tax benefit applicable to this OTTI loss amounted to \$477,208. There were no securities sold in 2009. During 2009, the Company recognized an OTTI on its investment in pooled trust preferred securities of \$658,714. The tax benefit applicable to this OTTI loss amounted to \$223,963.

For the year ended December 31, 2008, proceeds from sales of securities available for sale amounted to \$9.1 million. Gross realized gains amounted to \$87,585 in 2008. The tax expense applicable to this net realized gain amounted to \$29,779. In addition, the Company recognized an OTTI on its Freddie Mac preferred stock of \$422,500. The tax benefit applicable to this OTTI loss amounted to \$143,650.

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 December 31, 2010 and 2009.

| December 31, 2010<br>Description of<br>Securities                  | Less than 12 Months |                        | 12 Months or More |                        | Total         |                        |
|--|---------------------|------------------------|-------------------|------------------------|---------------|------------------------|
|  | Fair Value          | Unrealized<br>(Losses) | Fair Value        | Unrealized<br>(Losses) | Fair Value    | Unrealized<br>(Losses) |
| Obligations of U.S.<br>Government,<br>corporations and<br>agencies | \$ 24,409,268       | \$ (342,206 )          | \$ -              | \$ -                   | \$ 24,409,268 | \$ (342,206 )          |
| Obligations of<br>states and political<br>subdivisions             | 579,760             | (2,847 )               | -                 | -                      | 579,760       | (2,847 )               |
| Corporate Bonds  | -                   | -                      | 551,844           | (3,395,289)            | 551,844       | (3,395,289)            |
| Subtotal, debt<br>securities                                       | 24,989,028          | (345,053 )             | 551,844           | (3,395,289)            | 25,540,872    | (3,740,342)            |
| Mutual Funds   | -                   | -                      | 326,514           | (347 )                 | 326,514       | (347 )                 |
| Total temporary<br>impaired securities                             | \$ 24,989,028       | \$ (345,053 )          | \$ 878,358        | \$ (3,395,636)         | \$ 25,867,386 | \$ (3,740,689)         |
| December 31, 2009<br>Description of<br>Securities                  | Less than 12 Months |                        | 12 Months or More |                        | Total         |                        |
|  | Fair Value          | Unrealized<br>(Losses) | Fair Value        | Unrealized<br>(Losses) | Fair Value    | Unrealized<br>(Losses) |
| Obligations of U.S.<br>Government,<br>corporations and<br>agencies | \$ 3,030,782        | \$ (25,592 )           | \$ -              | \$ -                   | \$ 3,030,782  | \$ (25,592 )           |

|  |              |              |              |                |              |                |
|--|--------------|--------------|--------------|----------------|--------------|----------------|
| Obligations of states and political subdivisions | 312,667      | (174 )       | 275,475      | (8,584 )       | 588,142      | (8,758 )       |
| Corporate Bonds                                  | -            | -            | 1,912,456    | (3,428,830)    | 1,912,456    | (3,428,830)    |
| Subtotal, debt securities                        | 3,343,449    | (25,766 )    | 2,187,931    | (3,437,414)    | 5,531,380    | (3,463,180)    |
| Mutual Funds                                     | -            | -            | 312,263      | (3,451 )       | 312,263      | (3,451 )       |
| FHLMC Preferred Bank Stock                       | 14,700       | (3,800 )     | -            | -              | 14,700       | (3,800 )       |
| Total temporary impaired securities              | \$ 3,358,149 | \$ (29,566 ) | \$ 2,500,194 | \$ (3,440,865) | \$ 5,858,343 | \$ (3,470,431) |

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## Notes to Consolidated Financial Statements

The nature of securities which are temporarily impaired for a continuous 12 month period or more can be segregated into two groups.

The first group consists of four corporate bonds with a cost basis totaling \$3.95 million and a temporary loss of approximately \$3.40 million. The method for valuing these four corporate bonds came from Moody's Analytics. Moody's Analytics employs a two step discounted cash-flow valuation process. The first step is to use Monte Carlo simulations to evaluate the credit quality of the collateral pool and the structural supports. Step two is to apply a discount rate to the cash flows to calculate a value. These four corporate bonds are the "Class B" or subordinated "mezzanine" tranche of pooled trust preferred securities. Each of trust preferred securities are collateralized by the interest and principal payments made on trust preferred capital offerings by a geographically diversified pool of between 60 and 69 different financial institutions. They have an estimated maturity of 24 years. These bonds could have been called at par on the five year anniversary date of issuance, which has already passed for all four bonds. The bonds reprice every three months at a fixed rate index above the three-month London Interbank Offered Rate ("LIBOR"). These bonds have sufficient collateralization and cash flow projections to satisfy their valuation based on the cash flow portion of the OTTI test under authoritative accounting guidance as of December 31, 2010. All four bonds totaling \$552,000 at fair value, are greater than 90 days past due, and are classified as nonperforming corporate bond investments in the nonperforming asset table in Note 4.

Additional information regarding each of the pooled trust preferred securities as of December 31, 2010 follows:

| Cost, net of OTTI loss | Fair Value | Percent of Underlying Collateral Performing | Percent of Underlying Collateral in Deferral | Percent of Underlying Collateral in Default | Estimated defaults required to break yield (1) | incremental required to Moody's Rating | Current Rating | Cumulative Amount of OTTI Loss | Cumulative Other Comprehensive Loss, net of tax benefit |
|------------------------|------------|---|--|---|--|--|----------------|--------------------------------|---|
| \$359,294              | \$13,619   | 54.51%                                      | 29.81%                                       | 15.68%                                      | broken   | C                                      | \$640,706      | \$228,146                      |   |
| 1,682,320              | 327,332    | 70.31%                                      | 16.57%                                       | 13.12%                                      | broken   | Ca                                     | 317,680        | 894,292                        |   |
| 1,350,926              | 196,378    | 69.99%                                      | 22.47%                                       | 7.54%                                       | broken   | Ca                                     | 649,074        | 762,001                        |   |
| 554,593                | 14,515     | 64.99%                                      | 22.19%                                       | 12.82%                                      | broken   | C                                      | 445,407        | 356,451                        |   |
| \$3,947,133            | \$551,844  |   |  |   |  |  | \$2,052,867    | \$2,240,890                    |   |

(1) A break in yield for a given tranche investment means that defaults and/or deferrals have reached such a level that the specific tranche would not receive all of the contractual principal and interest cash flow by its maturity, resulting in not a temporary shortfall, but an actual loss. This column represents the percentage of additional defaults among the currently performing collateral that would result in other than temporary impairment and loss.

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

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



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## Notes to Consolidated Financial Statements

|   | Available for<br>sale |
|---|-----------------------|
| Beginning balance as of December 31, 2009   | \$ 658,714            |
| Add: Amount related to the credit loss for which an other-than- temporary impairment was not previously recognized  | 649,074               |
| Add: Increases to the amount related to the credit loss for which an other-than temporary impairment was previously recognized  | 754,479               |
| Less: Realized losses for securities sold   | -                     |
| Less: Securities for which the amount previously recognized in other comprehensive income was recognized in earnings because the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis | -                     |
| Less: Increases in cash flows expected to be collected that are recognized over the remaining life of the security (See FASB ASC 320-10-35-35)  | -                     |
| Ending balance as of December 31, 2010  | \$ 2,062,267          |

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$42.6 million and \$23.7 million at December 31, 2010 and 2009, respectively.

The amortized cost and fair value of restricted securities follows:

|                               | Amortized<br>Cost | December 31, 2010            |                                 | Fair Value   |
|-------------------------------|-------------------|------------------------------|---------------------------------|--------------|
|                               |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) |              |
| Restricted investments:       |                   |                              |                                 | -            |
| Federal Home Loan Bank Stock  | \$ 3,239,300      | \$ -                         | \$ -                            | \$ 3,239,300 |
| Federal Reserve Bank Stock    | 99,000            | -                            | -                               | 99,000       |
| Community Bankers' Bank Stock | 50,000            | -                            | -                               | 50,000       |
|                               | \$ 3,388,300      | \$ -                         | \$ -                            | \$ 3,388,300 |

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

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

December 31, 2010, and no impairment has been recognized.

Silverton Bank was closed by regulators on May 1, 2009. During the second quarter of 2009, the Company recorded an impairment of the entire investment totaling \$112,920. There was no tax benefit applicable to this OTTI loss.



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## Notes to Consolidated Financial Statements

## Note 3. Loans

A summary of the balances of loans follows:

|  | December 31,   |            |
|--|----------------|------------|
|  | 2010           | 2009       |
|  | (In Thousands) |            |
| Real estate loans:   |                |            |
| Construction   | \$ 27,390      | \$ 33,003  |
| Residential real estate                                      | 136,137        | 144,274    |
| Home equity lines of credit                                  | 51,023         | 49,435     |
| Commercial real estate                                       | 215,349        | 201,872    |
| Commercial and industrial loans (not secured by real estate) | 29,819         | 29,292     |
| Consumer loans   | 7,031          | 10,390     |
| Total loans  | 466,749        | 468,266    |
| Allowance for loan losses                                    | (6,307 )       | (5,482 )   |
| Net loans  | \$ 460,442     | \$ 462,784 |

## Note 4. Allowance for Loan Losses

Analysis of the allowance for loan losses follows:

|  | 2010         | 2009         | 2008         |
|--|--------------|--------------|--------------|
| Balance at beginning of year               | \$ 5,481,963 | \$ 4,779,662 | \$ 4,185,209 |
| Provision for loan losses                  | 2,075,000    | 1,710,000    | 3,227,269    |
| Recoveries of loans previously charged-off | 94,859       | 81,106       | 72,298       |
| Loan losses charged-off                    | (1,344,629)  | (1,088,805)  | (2,705,114)  |
| Balance at end of year                     | \$ 6,307,193 | \$ 5,481,963 | \$ 4,779,662 |

|   | 2010         | 2009         | 2008       |
|---|--------------|--------------|------------|
| Impaired loans for which an allowance has been provided | \$ 978,802   | \$ 3,213,516 | \$ 809,221 |
| Impaired loans for which no allowance has been provided | 446,361      | 175,429      | 81,604     |
|   | \$ 1,425,163 | \$ 3,388,945 | \$ 890,825 |

|  |            |              |            |
|--|------------|--------------|------------|
| Allowance provided for impaired loans, included in the allowance for loan losses | \$ 790,700 | \$ 1,163,072 | \$ 720,395 |
|--|------------|--------------|------------|

|                                   | 2010         | 2009         | 2008         |
|-----------------------------------|--------------|--------------|--------------|
| Average balance in impaired loans | \$ 1,508,082 | \$ 3,631,937 | \$ 1,308,909 |

|  |           |            |           |
|--|-----------|------------|-----------|
| Interest income recognized on impaired loans | \$ 57,815 | \$ 148,490 | \$ 35,940 |
|--|-----------|------------|-----------|

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## Notes to Consolidated Financial Statements

Allowance for Loan Losses  
For the Year Ended December 31, 2010

|   | Commercial<br>and<br>Industrial | Commercial<br>Real Estate | Commercial<br>Construction | Consumer   | Residential<br>Real Estate | Home<br>Equity Line<br>of Credit | Total        |
|---|---------------------------------|---------------------------|----------------------------|------------|----------------------------|----------------------------------|--------------|
| Allowance for<br>individually<br>evaluated for<br>impairment: |                                 |                           |                            |            |                            |                                  |              |
| Ending balance at<br>December 31,<br>2010                     | \$ 602,900                      | \$ 187,800                | \$ -                       | \$ -       | \$ -                       | \$ -                             | \$ 790,700   |
| Allowance for<br>collectively<br>evaluated for<br>impairment: |                                 |                           |                            |            |                            |                                  |              |
| Ending balance at<br>December 31,<br>2010                     | 189,896                         | 2,132,892                 | 150,513                    | 314,580    | 1,622,830                  | 1,105,782                        | 5,516,493    |
| Total allowance<br>for loan losses                            | \$ 792,796                      | \$ 2,320,692              | \$ 150,513                 | \$ 314,580 | \$ 1,622,830               | \$ 1,105,782                     | \$ 6,307,193 |

Analysis of the Loan Receivable Activity  
For the Year Ended December 31, 2010

|  | Commercial<br>and<br>Industrial | Commercial<br>Real Estate | Commercial<br>Construction | Consumer     | Residential<br>Real Estate | Home<br>Equity Line<br>of Credit | Total          |
|--|---------------------------------|---------------------------|----------------------------|--------------|----------------------------|----------------------------------|----------------|
| Individually<br>evaluated<br>for<br>impairment<br>balance: |                                 |                           |                            |              |                            |                                  |                |
| Ending<br>balance  | \$ 819,646                      | \$ 605,517                | \$ -                       | \$ -         | \$ -                       | \$ -                             | \$ 1,425,163   |
| Collectively<br>evaluated<br>for<br>impairment<br>balance: |                                 |                           |                            |              |                            |                                  |                |
| Ending<br>balance  | 28,998,802                      | 214,743,618               | 27,389,565                 | 7,031,226    | 136,137,440                | 51,022,985                       | 465,323,636    |
| Total Loans  | \$ 29,818,448                   | \$ 215,349,135            | \$ 27,389,565              | \$ 7,031,226 | \$ 136,137,440             | \$ 51,022,985                    | \$ 466,748,799 |

Credit Quality Indicators  
For the Year Ended December 31, 2010

| Grade:             | Commercial<br>and<br>Industrial | Commercial<br>Real Estate | Commercial<br>Construction | Consumer    | Residential<br>Real Estate | Home<br>Equity Line<br>of Credit | Total         |
|--------------------|---------------------------------|---------------------------|----------------------------|-------------|----------------------------|----------------------------------|---------------|
| Pass               | \$24,489,238                    | \$160,944,161             | \$22,854,565               | \$6,935,003 | \$129,087,024              | \$46,551,709                     | \$390,861,700 |
| Special<br>mention | 3,118,443                       | 41,077,145                | 4,535,000                  | 59,602      | 2,834,248                  | 1,839,000                        | 53,463,438    |
| Substandard        | 1,923,445                       | 13,327,829                | -                          | 36,621      | 3,880,454                  | 1,986,196                        | 21,154,545    |
| Doubtful           | 287,322                         | -                         | -                          | -           | 335,714                    | 646,080                          | 1,269,116     |
| Loss               | -                               | -                         | -                          | -           | -                          | -                                | -             |
| Total              | \$29,818,448                    | \$215,349,135             | \$27,389,565               | \$7,031,226 | \$136,137,440              | \$51,022,985                     | \$466,748,799 |

Credit Quality Information  
Age Analysis of Past Due Financing Receivables  
For the Year Ended December 31, 2010

|                                 | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>than 90<br>Days | Total Past<br>Due | Current       | Total<br>Financing<br>Receivables | Carrying<br>Amount<br>> 90<br>Days and<br>Accruing | Nonaccruals |
|---------------------------------|------------------------|------------------------|----------------------------|-------------------|---------------|-----------------------------------|--|-------------|
| Commercial<br>and<br>industrial | \$84,131               | \$98,475               | \$95,696                   | \$278,302         | \$29,540,146  | \$29,818,448                      | \$75,102   | \$368,771   |
| Commercial<br>real estate       | 427,995                | -                      | 187,490                    | 615,485           | 214,733,650   | 215,349,135                       | 187,490  | 312,672     |
| Commercial<br>construction      | -                      | -                      | -                          | -                 | 27,389,565    | 27,389,565                        | -  | -           |
| Consumer                        | 100,219                | -                      | -                          | 100,219           | 6,931,007     | 7,031,226                         | -  | 12,197      |
| Residential<br>real estate      | 1,208,344              | 551,353                | 502,119                    | 2,261,816         | 133,875,624   | 136,137,440                       | -  | 769,000     |
| Home equity<br>line of credit   | 363,641                | 351,792                | 612,018                    | 1,327,451         | 49,695,534    | 51,022,985                        | -  | 646,080     |
| Total                           | \$2,184,330            | \$1,001,620            | \$1,397,323                | \$4,583,273       | \$462,165,526 | \$466,748,799                     | \$262,592  | \$2,108,720 |

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## Notes to Consolidated Financial Statements

Impaired Financing Receivables  
For the Year Ended December 31, 2010

|                                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|--------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no specific allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial and industrial            | \$ 133,689             | \$ 133,689                     | \$ -                 | \$ 167,891                        | \$ 3,317                         |
| Commercial real estate               | 312,672                | 312,672                        | -                    | 333,554                           | -                                |
| Commercial construction              | -                      | -                              | -                    | -                                 | -                                |
| With an allowance recorded:          |                        |                                |                      |                                   |                                  |
| Commercial and industrial            | 829,092                | 829,092                        | 641,900              | 856,290                           | 46,044                           |
| Commercial real estate               | 149,710                | 149,710                        | 148,800              | 150,345                           | 8,454                            |
| Commercial construction              | -                      | -                              | -                    | -                                 | -                                |
| Total:                               |                        |                                |                      |                                   |                                  |
| Commercial and industrial            | 962,781                | 962,781                        | 641,900              | 1,024,181                         | 49,361                           |
| Commercial real estate               | 462,382                | 462,382                        | 148,800              | 483,899                           | 8,454                            |
| Commercial construction              | -                      | -                              | -                    | -                                 | -                                |
| Total                                | \$ 1,425,163           | \$ 1,425,163                   | \$ 790,700           | \$ 1,508,080                      | \$ 57,815                        |

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

The reduction in impaired loans of \$2.0 million from 2009 to 2010 primarily reflects the transfer to other real estate owned of two properties totaling approximately \$1.7 million.

The increase in impaired loans of \$2.5 million from 2008 to 2009 primarily reflects the addition of three commercial real estate properties totaling \$2.2 million. All three loans were collateralized by commercial building and/or land. Two of the loans, totaling \$1.7 million, were included in non-performing loans at December 31, 2009, and were transferred to other real estate owned in 2010.

Under authoritative accounting guidance, the above impaired loan disclosure does not exclude any non-accrual loans at December 31, 2010, 2009 and 2008. Loans past due 90 days or more and still accruing interest totaled \$263,000, \$354,000, and \$102,000 for 2010, 2009, and 2008, respectively.

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## Notes to Consolidated Financial Statements

NON-PERFORMING ASSETS AND LOANS CONTRACTUALLY PAST DUE  
(Dollars In Thousands)

|  | Years ended December 31, |          |          |          |          |
|--|--------------------------|----------|----------|----------|----------|
|  | 2010                     | 2009     | 2008     | 2007     | 2006     |
| Non-accrual loans  | \$ 2,109                 | \$ 3,410 | \$ 1,208 | \$ 1,906 | \$ 1,608 |
| Restructured loans*                                      | -                        | -        | -        | -        | -        |
| Other real estate owned                                  | 2,821                    | 2,480    | 3,034    | -        | -        |
| Other repossessed assets owned                           | 21                       | 54       | 33       | 222      | 140      |
| Non-performing corporate bond investments, at fair value | 552                      | 1,126    | -        | -        | -        |
| Total non-performing assets                              | \$ 5,503                 | \$ 7,070 | \$ 4,275 | \$ 2,128 | \$ 1,748 |
| Loans past due 90 days accruing interest                 | \$ 263                   | \$ 354   | \$ 102   | \$ 770   | \$ 1     |
| Allowance for loan losses to total loans                 | 1.35 %                   | 1.17 %   | 1.09 %   | 1.01 %   | 1.07 %   |
| Non-accrual loans to total loans                         | 0.45 %                   | 0.73 %   | 0.27 %   | 0.46 %   | 0.39 %   |
| Allowance for loan losses to non-performing loans        | 299.10 %                 | 160.76 % | 395.70 % | 219.57 % | 278.05 % |

\* Restructured loans on non-accrual status are included with non-accrual loans and not restructured loans. At December 31, 2010 there was one loan totaling \$255,000 that was both restructured and on non-accrual status.

## Note 5. Related Party Transactions

In the ordinary course of business, the Company has granted loans to executive officers, directors, their immediate families and affiliated companies in which they are principal shareholders, which totaled \$3,650,432 at December 31, 2010 and \$4,085,972 at December 31, 2009. During 2010, total principal additions were \$165,024 and total principal payments were \$600,564. During 2009, total principal additions were \$947,641 and total principal payments were \$841,347.

## Note 6. Bank Premises and Equipment, Net

A summary of the cost and accumulated depreciation of premises and equipment at December 31, 2010 and 2009 are as follows:

|                            | 2010         | 2009         |
|----------------------------|--------------|--------------|
| Land                       | \$ 2,573,684 | \$ 2,541,282 |
| Buildings and improvements | 14,778,771   | 8,345,011    |

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|   |               |               |
|---|---------------|---------------|
| Furniture and equipment                   | 9,067,135     | 8,038,106     |
| Leasehold improvements                    | 295,740       | 301,840       |
| Construction in process                   | 80,041        | 6,444,946     |
|   | 26,795,371    | 25,671,185    |
| Accumulated depreciation and amortization | (12,636,997)  | (11,645,440)  |
|   | \$ 14,158,374 | \$ 14,025,745 |

Depreciation and amortization expensed for years ended December 31, 2010, 2009, and 2008, totaled \$1,234,425, \$808,312, and \$909,922, respectively. In addition, during the year ended December 31, 2010, fixed assets totaling \$140,067 were deemed to be without value and disposed.

Note 7.

Deposits

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2010 and 2009 were \$100,581,000 and \$120,466,000 respectively. Of the \$100,581,000 of time deposits in denominations of \$100,000 or more at December 31, 2010, \$29,947,000 were in denominations above \$250,000. Brokered deposits include balances of Bank customers who qualify to participate in the CD Account Registry Services (“CDARS”). As of December 31, 2010 and 2009, brokered balances totaled \$39,271,000 and \$57,300,000, respectively.

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## Notes to Consolidated Financial Statements

At December 31, 2010, the scheduled maturities of time deposits are as follows:

(In Thousands)

|                |            |
|----------------|------------|
| 2011           | \$ 83,463  |
| 2012           | 47,155     |
| 2013           | 10,313     |
| 2014           | 8,493      |
| 2015           | 21,459     |
| and thereafter | 4,880      |
|                | \$ 175,763 |

Overdraft deposits totaling \$213,449 and \$237,968 were reclassified to loans at December 31, 2010 and 2009, respectively.

The Bank accepts deposits of executive officers, directors, their immediate families and affiliated companies in which they are principal shareholders on the same terms, including interest rates, as those prevailing at the time of comparable transactions with unrelated persons. The aggregate dollar amount of deposits of executive officers and directors totaled \$1,195,000 and \$5,929,000 at December 31, 2010 and 2009, respectively.

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## Notes to Consolidated Financial Statements

## Note 8.

## Employee Benefit Plans

## Defined Benefit Plan

The following tables provide a reconciliation of the changes in the defined benefit plan's obligations and fair value of assets over the three-year period ending December 31, 2010.

|   | 2010         | 2009          | 2008         |
|---|--------------|---------------|--------------|
| <b>Change in Benefit Obligations</b>      |              |               |              |
| Benefit obligation, beginning             | \$ 6,730,628 | \$ 6,251,895  | \$ 6,962,121 |
| Service cost                              | -            | 250,828       | 555,404      |
| Interest cost                             | 318,090      | 295,307       | 386,758      |
| Actuarial gain (loss)                     | -            | 5,765         | 1,170,367    |
| Benefits paid                             | (7,203,754)  | (73,167 )     | (191,301 )   |
| Decrease in obligation due to curtailment | -            | -             | (2,631,454)  |
| Loss due to settlement                    | 155,036      | -             | --           |
| Prior service cost due to amendment       | -            | -             | -            |
| Benefit obligation, ending                | \$ -         | \$ 6,730,628  | \$ 6,251,895 |
| <b>Change in Plan Assets</b>              |              |               |              |
| Fair value of plan assets, beginning      | \$ 6,451,614 | \$ 6,537,913  | \$ 7,051,968 |
| Actual return on plan assets              | (12,678 )    | (13,132 )     | (322,754 )   |
| Employer contributions                    | 764,818      | -             | -            |
| Benefits paid                             | (7,203,754)  | (73,167 )     | (191,301 )   |
| Fair value of plan assets, ending         | \$ -         | \$ 6,451,614  | \$ 6,537,913 |
| Funded status, ending                     | \$ -         | \$ (279,014 ) | \$ 286,018   |

|   | 2,010 | 2,009      | 2008      |
|---|-------|------------|-----------|
| <b>Amount recognized on the Balance Sheet</b> |       |            |           |
| Other assets                                  | \$-   | \$-        | \$286,018 |
| Other liabilities                             | -     | -          | -         |
| Other comprehensive income (loss)             | -     | (279,014 ) | -         |

|   |              |           |     |
|---|--------------|-----------|-----|
| <b>Amounts Recognized in accumulated other comprehensive loss</b> |              |           |     |
| Net loss  | (279,014 )   | 279,014   | -   |
| Prior service cost  | -            | -         | -   |
| Net obligation at transition                                      | -            | -         | -   |
| Deferred tax benefit  | 94,865       | (94,865 ) | -   |
| Amount recognized   | \$(184,149 ) | \$184,149 | \$- |

|   |     |               |               |
|---|-----|---------------|---------------|
| <b>Funded Status</b>                      |     |               |               |
| Benefit Obligation                        | \$- | \$(6,730,628) | \$(6,251,895) |
| Fair value of assets                      | -   | 6,451,614     | 6,537,913     |
| Unrecognized net actuarial (gain)/loss    | -   | 279,014       | -             |
| Unrecognized net obligation at transition | -   | -             | -             |



|  |     |     |           |
|--|-----|-----|-----------|
| Unrecognized prior service cost  | -   | -   | -         |
| Prepaid (accrued) benefit cost included in other assets<br>(liabilities) | \$- | \$- | \$286,018 |

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## Notes to Consolidated Financial Statements

|  | 2010       | 2009       | 2008          |
|--|------------|------------|---------------|
| Components of Net Periodic Benefit Cost                    |            |            |               |
| Service cost   | \$ -       | \$ 250,828 | \$ 444,323    |
| Interest cost  | 318,090    | 295,307    | 309,406       |
| Expected return on plan assets                             | (256,702 ) | (260,117 ) | (596,201 )    |
| Amortization of prior service cost                         | -          | -          | 7,766         |
| Amortization of net obligation at transition               | -          | -          | (18,979 )     |
| Recognized net loss(gain) due to curtailment or settlement | 703,430    | -          | (327,269 )    |
| Recognized net actuarial loss                              | -          | -          | -             |
| Net periodic benefit cost                                  | \$ 764,818 | \$ 286,018 | \$ (180,954 ) |

Other Changes in Plan Assets and Benefit Obligations  
Recognized in Other Comprehensive Income.

|  | 2010          | 2009       | 2008         |
|--|---------------|------------|--------------|
| Net (gain)/loss  | \$ (279,014 ) | \$ 279,014 | \$ (96,632 ) |
| Prior service cost   | -             | -          | (21,368 )    |
| Amortization of prior service cost                         | -             | -          | (9,708 )     |
| Net obligation at transition                               | -             | -          | 52,184       |
| Amortization of Net Obligation at Transition               | -             | -          | 23,724       |
| Total recognized   | (279,014 )    | 279,014    | (51,800 )    |
| Income tax expense (benefit)                               | (94,865 )     | 94,865     | (17,612 )    |
| Net amount recognized in other comprehensive (income) loss | \$ (184,149 ) | \$ 184,149 | \$ (34,188 ) |

## Total Recognized in Net Periodic Benefit Costs and Other Comprehensive (Income) Loss:

| 2010       | 2009       | 2008         |
|------------|------------|--------------|
| \$ 485,804 | \$ 565,032 | \$ (232,754) |

The accumulated benefit obligation for the deferred benefit pension plan was distributed during 2010, and as a result, there was no accumulated benefit obligation at December 31, 2010. The accumulated benefit obligation for the deferred benefit pension plan was \$6,730,628 and \$5,977,222 at December 31, 2009 and 2008, respectively.

The assumptions used in the measurement of the Company's benefit obligations are shown in the following table:

|   | 2010   | 2009   | 2008   |
|---|--------|--------|--------|
| Weighted-Average Assumptions used in computing ending obligations as of December 31 |        |        |        |
| Discount rate   | N/A    | 4.75 % | 6.25 % |
| Expected return on plan assets  | 4.00 % | 4.00 % | 8.50 % |
| Rate of compensation increase   | 4.00 % | 4.00 % | 4.00 % |



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## Notes to Consolidated Financial Statements

The assumptions used in the measurement of the Company's Net Periodic Benefit Cost are shown in the following table:

|   | 2010 |   | 2009 |   | 2008 |   |
|---|------|---|------|---|------|---|
| Weighted-Average Assumptions used in computing ending obligations as of December 31 |      |   |      |   |      |   |
| Discount rate   | 4.75 | % | 4.75 | % | 4.75 | % |
| Expected return on plan assets  | 4.00 | % | 4.00 | % | 8.50 | % |
| Rate of compensation increase   | 4.00 | % | 4.00 | % | 4.00 | % |

The plan sponsor selects the expected long-term rate of return on assets assumption in consultation with their advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience - that may not continue over the measurement period - with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment), typically paid from the plan assets (to the extent such expenses are not explicitly estimated within periodic costs).

The Company pension plan's weighted-average asset allocation at December 31, 2009 and 2008, by asset category are as follows:

| Asset Category as of December 31, | 2009 |   | 2008 |   |
|-----------------------------------|------|---|------|---|
| Mutual Funds - Fixed Income       | 0    | % | 0    | % |
| Mutual Funds - Equity             | 0    | % | 0    | % |
| Cash and Cash Equivalents         | 100  | % | 100  | % |
| Total                             | 100  | % | 100  | % |

Beginning in January 2008, 100% of the Company's pension plan assets were invested in cash and cash equivalents. This decision was based on recognizing the need to preserve asset value until December 31, 2009, the effective date of the termination of the defined benefit pension plan. All of the plan's assets are considered level one in the fair value hierarchy. Prior to January 2008, the investment manager of the trust fund selected investment fund managers with demonstrated experience and expertise, and the funds with demonstrated historical performance, for the implementation of the plan's investment strategy. The investment manager both actively and passively managed investment strategies and allocated funds across the asset classes to develop an efficient investment structure.

The Company made a \$764,818 contribution to its pension plan in 2010. The Company made no contribution to its pension plan in 2009 and 2008.

On December 20, 2008, the Company's Board of Directors approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010 replace the defined benefit pension plan with an

enhanced 401(k) plan. On August 16, 2010, the Company received a favorable determination letter dated August 12, 2010 from the Internal Revenue Service for the December 31, 2009 termination date. Between January 1, 2010 and December 10, 2010, the Company distributed \$7,203,754 of pension benefits, of which \$7,086,067 was distributed between November 30, 2010 and December 10, 2010, and represented the final distribution upon the plan's termination. On February 1, 2011, the Company filed a Post-Distribution Certification for Standard Termination with the Pension Benefit Guaranty Corporation.

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## Notes to Consolidated Financial Statements

## Supplemental Executive Retirement Plan

The following tables provide a reconciliation of the changes in the supplemental executive retirement plan's obligations over the three-year period ending December 31, 2010, computed as of December 31, 2010, 2009 and 2008.

|   | 2010           | 2009           | 2008           |
|---|----------------|----------------|----------------|
| <b>Change in Benefit Obligations</b>                              |                |                |                |
| Projected benefit obligation, beginning                           | \$ 1,410,954   | \$ 1,740,590   | \$ 1,170,236   |
| Service cost  | 118,478        | 188,139        | 148,093        |
| Interest cost   | 84,637         | 104,410        | 70,203         |
| Actuarial gain (loss)   | 256,582        | (622,185 )     | 352,058        |
| Benefits paid   | -              | -              | -              |
| Prior service cost due to amendment                               | (556,145 )     | -              | -              |
| Benefit obligation, ending  | \$ 1,314,506   | \$ 1,410,954   | \$ 1,740,590   |
| Fair value of plan assets, ending                                 | \$ -           | \$ -           | \$ -           |
| Funded status at December 31,                                     | \$ (1,314,506) | \$ (1,410,954) | \$ (1,740,590) |
| <b>Amount recognized on the Balance Sheet</b>                     |                |                |                |
| Other assets, deferred income tax benefit                         | \$ -           | \$ 82,809      | \$ 313,055     |
| Other liabilities   | 1,314,506      | 1,410,277      | 1,740,590      |
| Other comprehensive income (loss)                                 | 57,684         | (160,746 )     | (607,695 )     |
| <b>Amounts Recognized in accumulated other comprehensive loss</b> |                |                |                |
| Net gain (loss)   | \$ (70,433 )   | \$ (342,508 )  | \$ 287,802     |
| Prior service cost  | (16,967 )      | 586,063        | 632,948        |
| Net obligation at transition                                      | -              | -              | -              |
| Deferred tax benefit (expense)                                    | 29,716         | (82,809 )      | (313,055 )     |
| Amount recognized   | \$ (57,684 )   | \$ 160,746     | \$ 607,695     |
| <b>Funded Status</b>  |                |                |                |
| Benefit Obligation  | \$ (1,314,506) | \$ (1,410,954) | \$ (1,740,590) |
| Fair value of assets  | -              | -              | -              |
| Unrecognized net actuarial (gain)/loss                            | -              | -              | -              |
| Unrecognized net obligation at transition                         | -              | -              | -              |
| Unrecognized prior service cost                                   | -              | -              | -              |
| (Accrued)/prepaid benefit cost included in other liabilities      | \$ (1,314,506) | \$ (1,410,954) | \$ (1,740,590) |

|   | 2010 | 2009 | 2008 |
|---|------|------|------|
| Components of Net Periodic Benefit Cost |      |      |      |

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|  |            |            |            |
|--|------------|------------|------------|
| Service cost                                 | \$ 118,478 | \$ 188,139 | \$ 148,093 |
| Interest cost                                | 84,637     | 104,410    | 70,203     |
| Expected return on plan assets               | -          | -          | -          |
| Amortization of prior service cost           | 46,885     | 46,885     | 46,885     |
| Amortization of net obligation at transition | -          | -          | -          |
| Recognized net actuarial (loss) gain         | (15,493 )  | 8,125      | -          |
| Net periodic benefit cost                    | \$ 234,507 | \$ 347,559 | \$ 265,181 |

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## Notes to Consolidated Financial Statements

## Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive Income.

|  | 2010          | 2009          | 2008       |
|--|---------------|---------------|------------|
| Net (gain)/loss  | \$ 272,075    | \$ (630,310 ) | \$ 352,058 |
| Prior service cost   | (556,145 )    | -             | -          |
| Amortization of prior service cost                         | (46,885 )     | (46,885 )     | (46,885 )  |
| Net obligation at transition                               | -             | -             | -          |
| Amortization of Net Obligation at Transition               | -             | -             | -          |
| Total recognized   | (330,955 )    | (677,195 )    | 305,173    |
| Less: Income Tax Effect                                    | (112,525 )    | (230,246 )    | 103,759    |
| Net amount recognized in other comprehensive (income) loss | \$ (218,430 ) | \$ (446,949 ) | \$ 201,414 |

Total Recognized in Net Periodic Benefit Costs and Other Comprehensive (Income) Loss before income tax.

| 2010        | 2009         | 2008       |
|-------------|--------------|------------|
| \$ (96,448) | \$ (329,636) | \$ 570,354 |

The assumptions used in the measurement of the Company's benefit obligations are shown in the following table.

|   | 2010   | 2009   | 2008   |
|---|--------|--------|--------|
| Weighted-Average Assumptions used in computing ending obligations as of December 31 |        |        |        |
| Discount rate used for net periodic pension cost                                    | 6.00 % | 6.00 % | 6.00 % |
| Discount rate used for disclosures  | 5.50 % | 6.00 % | 6.00 % |
| Expected return on plan assets  | N/A    | N/A    | N/A    |
| Rate of compensation increase   | 4.00 % | 4.00 % | 4.00 % |

Estimated future benefit payments which reflect expected future service, as appropriate, are as follows.

| Payment Dates            | Amount  |
|--------------------------|---------|
| For the 12 months ended: |         |
| December 31, 2011        | \$ 928  |
| December 31, 2012        | 2,030   |
| December 31, 2013        | 3,336   |
| December 31, 2014        | 4,882   |
| December 31, 2015        | 29,113  |
| Thereafter               | 638,651 |



#### 401(k) Plan

The Company has a defined contribution retirement plan under Internal Revenue Code (“Code”) Section 401(k) covering employees who have completed 3 months of service and who are at least 18 years of age. Under the plan, a participant may contribute an amount up to 100% of their covered compensation for the year, not to exceed the dollar limit set by law (Code Section 402(g)). The Company will make, an annual matching contribution, equal to 100% on the first 1% of compensation deferred and 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 the years ended December 31, 2010, 2009 and 2008 were \$662,000 \$154,000, and \$142,000, respectively.

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Notes to Consolidated Financial Statements

Deferred Compensation Plan

The Company has a nonqualified deferred compensation program for a former key employee's retirement, in which the contribution expense is solely funded by the Company. The retirement benefit to be provided is variable based upon the performance of underlying life insurance policy assets. Deferred compensation expense amounted to \$5,532, \$9,409, and \$5,220 for the years ended December 31, 2010, 2009, and 2008, respectively.

Concurrent with the establishment of the deferred compensation plan, the Company purchased life insurance policies on this employee with the Company named as owner and beneficiary. These life insurance policies are intended to be utilized as a source of funding the deferred compensation plan. The Company has recorded in other assets \$1,112,442 and \$1,077,553 representing cash surrender value of these policies for the years ended December 31, 2010 and 2009, respectively.

Note 9. Dividend Reinvestment and Stock Purchase Plan

In 2004, the Company implemented a dividend reinvestment and stock purchase plan (the "DRSPP") that allows participating shareholders to purchase additional shares of the Company's common stock through automatic reinvestment of dividends or optional cash investments at 100% of the market price of the common stock, which is either the actual purchase price of the shares if obtained on the open market, or the average of the closing bid and asked quotations for a share of common stock on the day before the purchase date for shares if acquired directly from the Company as newly issued shares under the DRSPP. No new shares were issued during 2010, 2009, or 2008. The Company has 236,529 shares available for issuance under the DRSPP at December 31, 2010.

Note 10. Commitments and Contingent Liabilities

The Bank has entered into four banking facility leases of greater than one year.

The first lease was entered into on January 31, 1999. The lease provides for an original five-year term with a renewal option for additional periods of five years on the Bank's Sudley Road, Manassas branch. The Bank renewed the lease January 31, 2004 and again on January 31, 2009. Rent for 2011 is expected to be \$220,000.

The second lease for a branch office in Old Town Manassas was entered into on April 10, 2001, and was renegotiated in January 2011. The renegotiated lease begins on May 31, 2011 and provides for an original five-year term with the right to renew for one additional five-year periods beginning on June 1, 2016. Annual rent is \$47,746 for the first five years.

The third lease is for the property in Haymarket, Virginia where the Bank opened its ninth full-service branch office in December 2009. The term of the lease is 20 years after the branch opening with two additional options for five years each. The projected rent for 2011 is \$167,892, and will increase 3% annually.

The fourth lease is for the property in Bristow, Virginia where the Bank opened its tenth full-service branch office in July 2009. The lease will expire ten years after the branch opening with two additional options for five years each. The projected rent for 2011 is \$152,250, and will increase 3% annually.

Total rent expense was \$577,693, \$520,464, and \$300,438, for 2010, 2009, and 2008, respectively, and was included in occupancy expense.



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## Notes to Consolidated Financial Statements

The Bank has two data processing contractual obligations of greater than one year. The contractual expense for the Bank's largest primary contractual obligation is for core data processing, and totaled \$894,569 and \$891,024 for 2010 and 2009, respectively. In addition to core data processing, this contract provides for interchange processing where the expense is based on interchange volume. The interchange expense for 2010 was \$463,701, but was offset by interchange fees charged to our customers. The term of the current data processing obligation began in July 2009, and ends in June 2015.

The following is a schedule by year of future minimum lease requirements and contractual obligations required under the long-term non-cancellable lease agreements:

|            |              |
|------------|--------------|
| 2011       | \$2,005,893  |
| 2012       | 1,969,241    |
| 2013       | 2,024,447    |
| 2014       | 2,111,500    |
| 2015       | 1,383,518    |
| Thereafter | 7,884,387    |
| Total      | \$17,378,986 |

As a member of the Federal Reserve System, the Company's subsidiary bank is required to maintain certain average reserve balances. For the final weekly reporting period in the years ended December 31, 2010 and 2009, the aggregate amounts of daily average required balances were approximately \$14,700,000 and \$6,939,000, respectively.

In the normal course of business, there are various outstanding commitments and contingent liabilities, such as guarantees, commitments to extend credit, etc., which are not reflected in the accompanying consolidated financial statements. The Company does not anticipate a material impact on its financial statements.

See Note 16 with respect to financial instruments with off-balance-sheet risk.

Note 11. Income Taxes

The Company files income tax returns in the U.S. federal jurisdiction and the state of Virginia. With few exceptions, the Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2007.

The components of the net deferred tax assets included in other assets at December 31, 2010 and 2009 are as follows:

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## Notes to Consolidated Financial Statements

|                               | 2010         | 2009         |
|-------------------------------|--------------|--------------|
| Deferred tax assets:          |              |              |
| Allowance for loan losses     | \$ 2,144,446 | \$ 1,863,867 |
| Securities available for sale | 1,099,301    | 812,808      |
| Impairment on securities      | 883,214      | 406,006      |
| Interest on nonaccrual loans  | 15,336       | 55,949       |
| Accrued vacation              | 133,450      | 123,137      |
| SERP obligation               | 446,673      | 534,977      |
| Accumulated depreciation      | 130,951      | 63,717       |
| Restricted Stock              | 123,208      | 192,202      |
| Accrued pension liability     | -            | 94,865       |
| Other                         | 291,680      | 195,777      |
|                               | 5,268,259    | 4,343,305    |
| Deferred tax liabilities:     |              |              |
| Other                         | 780          | 2,991        |
| Prepaid pension obligation    | -            | -            |
| Accumulated depreciation      | -            | -            |
|                               | 780          | 2,991        |
| Net deferred tax assets       | \$ 5,267,479 | \$ 4,340,314 |

The Company has not recorded a valuation allowance for deferred tax assets as they feel it is more likely than not, that they will be ultimately realized.

Allocation of federal income taxes between current and deferred portions is as follows:

|                        | Year Ended December 31, |              |              |
|------------------------|-------------------------|--------------|--------------|
|                        | 2010                    | 2009         | 2008         |
| Current tax expense    | \$ 1,947,326            | \$ 2,030,384 | \$ 2,027,484 |
| Deferred tax (benefit) | (854,412 )              | (874,440 )   | (661,835 )   |
|                        | \$ 1,092,914            | \$ 1,155,944 | \$ 1,365,649 |

The reasons for the difference between the statutory federal income tax rate and the effective tax rates for the three years ended December 31, 2010 are summarized as follows:

|  | 2010         | 2009         | 2008         |
|--|--------------|--------------|--------------|
| Computed "expected" tax expense          | \$ 1,618,472 | \$ 1,554,962 | \$ 1,706,244 |
| Decrease in income taxes resulting from: |              |              |              |
| Tax-exempt interest income               | (421,749 )   | (369,404 )   | (337,946 )   |
| Other                                    | (103,809 )   | (29,617 )    | (2,649 )     |
|  | \$ 1,092,914 | \$ 1,155,941 | \$ 1,365,649 |

Note 12.

Earnings Per Share

The following shows the weighted average number of shares used in computing earnings per share and the effect on the weighted average number of shares of diluted potential common stock.

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## Notes to Consolidated Financial Statements

|   | 2010      |                  | 2009      |                  | 2008      |                  |
|---|-----------|------------------|-----------|------------------|-----------|------------------|
|   | Shares    | Per Share Amount | Shares    | Per Share Amount | Shares    | Per Share Amount |
| Basic earnings per share                          | 3,627,016 | \$ 1.01          | 3,593,337 | \$ 0.95          | 3,525,821 | \$ 1.04          |
| Effect of dilutive securities, stock-based awards | 16,093    |                  | 9,494     |                  | 31,856    |                  |
| Diluted earnings per share                        | 3,643,109 | \$ 1.01          | 3,602,831 | \$ 0.95          | 3,557,677 | \$ 1.03          |

There were 23,732 options with a strike price above the Company's common stock closing sales price on December 31, 2010 of \$12.94 that were excluded from the earnings per share calculation. There were 23,732 options with a strike price above the Company's common stock closing sales price on December 31, 2009 of \$12.35 that were excluded from the earnings per share calculation.

Note 13.

### Stock Incentive Plans

#### Stock Incentive Plan (2009)

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

Under the Plan, stock options, stock appreciation rights, non-vested and/or restricted shares, and long-term performance unit awards may be granted to directors and certain key employees for purchase of the Company's stock. The effective date of the plan was March 19, 2009 and a termination date no later than December 31, 2019. The Company's board may terminate, suspend or modify the Plan within certain restrictions. The Plan authorized 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; however, for those individuals who own more than 10% of the stock of the Company and are awarded an incentive stock option, the option price must be at least 110% of the fair market value on the date of 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 key employees are generally subject to vesting requirements and are subject to forfeiture if vesting and other contractual provision requirements are not met.

#### Non-employee Director Stock Option Plan

The Company previously has issued stock options to non-employee directors under its Non-employee Director Stock Option Plan, which expired in 1999. Under that plan, each non-employee director of the Company or its subsidiary

received an option grant covering 2,240 shares of Company common stock on April 1 of each year during the five-year term of the plan. The first grant under the plan was made on May 1, 1995. The exercise price of awards was fixed at the fair market value of the shares on the date the option was granted. During the term of the plan, options for a total of 120,960 shares of common stock were granted. Effective January 1, 2000, the Omnibus Stock Ownership and Long-Term Incentive Plan for employees was amended and restated to include non-employee directors. The Company did not grant options in 2010, 2009, and 2008.

#### Restricted Shares

The restricted shares are accounted for using the fair market value of the Company's common stock on the date the restricted shares were awarded. The restricted shares issued to certain officers are subject to a vesting period, whereby, the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded. Compensation expense for these shares is accrued over the three year period. During the quarter ended March 31, 2010, the restricted shares previously issued to non-employee directors were no longer subject to a vesting period, and the previously deferred compensation expense on these shares was fully recognized during 2010. In future years starting in 2011, compensation expense for the non-employee director shares will be recognized at the date the shares are granted.



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## Notes to Consolidated Financial Statements

During 2010, 2009, and 2008, the Company granted awards of non-vested shares to certain officers and vested shares (effective March 31, 2010) to non-employee directors under the Omnibus Stock Ownership and Long-Term Incentive Plan: 9,784; 15,050; and 14,067 of non-vested restricted stock to executive officers and 5,553; 8,450; and 5,625 of vested restricted stock to directors on March 5, 2010; February 18, 2009; and February 17, 2008, respectively. Compensation expense for vested and non-vested shares, net of forfeiture and tax effect, amounted to \$246,789 in 2010, including an acceleration for previously deferred expense; and \$208,666; and \$263,575 in 2009, and 2008, respectively.

The Company granted 9,784 and 15,050 of performance-based stock rights to certain officers on March 5, 2010 and February 18, 2009, respectively, under the Omnibus Stock Ownership and Long-Term Incentive Plan.

The performance-based stock rights are accounted for using the fair market value of the Company's common stock on the date the restricted shares were awarded, and adjusted as the market value of the stock changes. The performance-based stock rights shares issued to executive officers and directors are subject to a vesting period, whereby, the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded. They are also subject to the Company reaching a predetermined return on average equity ratio for the final year of the vesting period. Compensation expense for performance-based stock rights amounted to \$105,890 in 2010 and \$64,280 in 2009.

A summary of the status of the Omnibus Stock Ownership and Long-Term Incentive Plan and Non-employee Director Stock Option Plan is presented below:

|   | 2010             |                                 | 2009                          |                  | 2008                            |                  |                                 |
|---|------------------|---------------------------------|-------------------------------|------------------|---------------------------------|------------------|---------------------------------|
|   | Number of Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value (1) | Number of Shares | Weighted Average Exercise Price | Number of Shares | Weighted Average Exercise Price |
| Outstanding at January 1,   | 62,480           | \$ 9.96                         |                               | 77,180           | \$ 9.84                         | 96,100           | \$ 9.85                         |
| Granted   | -                |                                 |                               | -                |                                 | -                |                                 |
| Exercised   | (20,214)         | 8.12                            |                               | (10,720)         | 9.15                            | (18,920)         | 9.91                            |
| Expired   |                  |                                 |                               | (3,980)          | 9.75                            |                  |                                 |
| Forfeited   | -                |                                 |                               | -                |                                 | -                |                                 |
| Outstanding at December 31,   | 42,266           | \$ 10.84                        | \$ 88,837                     | 62,480           | \$ 9.96                         | 77,180           | \$ 9.84                         |
| Weighted-average fair value per option of options granted during the year | \$ -             |                                 |                               | \$ -             |                                 | \$ -             |                                 |

(1) The aggregate intrinsic value of stock options in the table above reflects the pre-tax intrinsic value (the amount by which the December 31, 2010 market value of the underlying stock option exceeded the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2010. The aggregate intrinsic value will change based on the changes in the market value of the Company's stock.

The total intrinsic value of options exercised during the years ended December 31, 2010, 2009, and 2008 was \$161,271, \$35,838, and \$132,774, respectively.

The status of the options outstanding as of December 31, 2010 for the Omnibus Stock Ownership and Long-Term Incentive and Non-employee Director Stock Option Plans is as follows:

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## Notes to Consolidated Financial Statements

| Remaining Contractual Life | Options Outstanding |                                 | Options Exercisable |                                 |
|----------------------------|---------------------|---------------------------------|---------------------|---------------------------------|
|                            | Number Outstanding  | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
| 1.13 years                 | 18,534              | \$ 8.07                         | 18,534              | \$ 8.07                         |
| 2.08 years                 | 23,732              | \$ 13.00                        | 23,732              | \$ 13.00                        |
|                            | 42,266              |                                 | 42,266              |                                 |

A summary of the status of the Company's nonvested shares is presented below:

|                           | 2010      |  | 2009      |  | 2008      |  |
|---------------------------|-----------|--|-----------|--|-----------|--|
|                           | Shares    | Weighted Average Grant Date Fair Value | Shares    | Weighted Average Grant Date Fair Value | Shares    | Weighted Average Grant Date Fair Value |
| Nonvested at January 1,   | 47,282    |  | 38,219    |  | 31,190    |  |
| Granted                   | 15,337    | \$ 13.78                               | 23,500    | \$ 10.06                               | 19,692    | \$ 17.70                               |
| Vested                    | (28,847 ) |  | (10,585 ) |  | (10,315 ) |  |
| Forfeited                 | -         |  | (3,852 )  | \$ 13.78                               | (2,348 )  | \$ 21.13                               |
| Nonvested at December 31, | 33,772    |  | 47,282    |  | 38,219    |  |

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

|                           | 2010                           |   | 2009                           |   |
|---------------------------|--------------------------------|---|--------------------------------|---|
|                           | Performance Based Stock Rights | Weighted Average Fair Value at 12/31/2010 | Performance Based Stock Rights | Weighted Average Fair Value at 12/31/2009 |
| Nonvested at January 1,   | 13,524                         |   | -                              |   |
| Granted                   | 9,784                          |   | 15,500                         |   |
| Vested                    | -                              |   | -                              |   |
| Forfeited                 | -                              |   | (1,976 )                       |   |
| Nonvested at December 31, | 23,308                         | \$ 12.94                                  | 13,524                         | \$ 12.35                                  |

As of December 31, 2010, there was \$105,706 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. This type of deferred compensation cost is recognized over a period of three years.

Cash received from options exercised, exclusive of tax benefit, under all share based payment arrangements for the years ended December 31, 2010, 2009, and 2008, were \$164,160, \$98,040, and \$187,521, respectively. The actual tax benefit realized for the tax deductions from options exercised were \$45,143, \$10,162 and \$54,832 for 2010, 2009 and 2008, respectively.

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## Notes to Consolidated Financial Statements

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.

## Note 14. Federal Home Loan Bank Advances and Other Borrowings

The Company's borrowings from the FHLB was \$25.0 million at December 31, 2010 and \$50.0 million at December 31, 2009. At December 31, 2010 and 2009, the interest rates on FHLB advances ranged from 4.46% to 3.02% and from 4.46% to 0.00%, respectively. At December 31, 2010 and 2009, the weighted average interest rates were 3.91% and 2.19%, respectively. On December 31, 2010, one advance totaling \$10,000,000 was at adjustable rates based on the three month LIBOR, and three advances totaling \$15,000,000 were at various fixed rates.

At December 31, 2010, the Bank had an available line of credit with the FHLB with a borrowing limit of approximately \$118.7 million. FHLB advances and available line of credit were secured by certain first and second lien loans on one-to-four unit single-family dwellings and eligible commercial real estate loans of the Bank. As of December 31, 2010, the book value of eligible loans totaled approximately \$246.1 million. At December 31, 2009, the advances were secured by similar loans totaling \$218.5 million. The amount of available credit is limited to 75% of qualifying collateral for one-to-four unit single-family residential loans, and 50% for commercial and home equity loans. Any borrowing in excess of the qualifying collateral requires pledging of additional assets. The contractual maturities of FHLB advances are as follow s:

|             | 2010          | 2009          |
|-------------|---------------|---------------|
| Due in 2010 | \$ -          | \$ 15,000,000 |
| Due in 2011 | -             | 10,000,000    |
| Due in 2013 | 15,000,000    | 15,000,000    |
| Due in 2014 | 10,000,000    | 10,000,000    |
|             | \$ 25,000,000 | \$ 50,000,000 |

As additional sources of liquidity, the Bank has available federal funds purchased lines of credit with nine different commercial banks, including the Federal Reserve Bank of Richmond, totaling \$59.2 million. At December 31, 2010, none of the available federal funds purchased lines of credit with various commercial banks were in use.

## Note 15. Dividend Limitations on Affiliate Bank

Transfers of funds from the banking subsidiary to the parent corporation in the form of loans, advances and cash dividends are restricted by federal and state regulatory authorities. As of December 31, 2010, the aggregate amount of unrestricted funds, which could be transferred from the banking subsidiary to the parent corporation, without prior regulatory approval, totaled \$3.46 million.



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## Notes to Consolidated Financial Statements

## Note 16. Financial Instruments With Off-Balance-Sheet Risk

The Company is party to credit-related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2010 and 2009, the following financial instruments were outstanding whose contract amounts represent credit risk:

| (In Thousands)  | 2010      | 2009      |
|---|-----------|-----------|
| Financial instruments<br>whose contract amounts<br>represent credit risk: |           |           |
| Commitments to extend<br>credit   | \$ 62,798 | \$ 71,523 |
| Standby letters of credit   | 4,412     | 8,585     |
|   | \$ 67,210 | \$ 80,108 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Company is committed.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company generally holds collateral supporting those commitments if deemed necessary.

## Note 17. Derivative Instruments and Hedging Activities

Generally accepted accounting principles require that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the date that the derivative contract was entered into, the Company designated the derivative as a hedge of variable cash flows to be paid in conjunction with recognized liabilities, or a cash-flow 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.

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.



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## Notes to Consolidated Financial Statements

The Company follows generally accepted accounting principles, “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.

The Company entered into an interest rate swap agreement on July 1, 2010. The Bank uses the interest rate swap to reduce interest rate risks and to manage interest income, specifically with regard to the interest rate expense on its Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. By entering into this agreement, the Company converts a floating rate liability priced at three month LIBOR plus 1.70% into a fixed rate liability priced at 4.91% through 2020. Interest differentials paid or received under the swap agreements are reflected as adjustments to interest income. These interest rate swap agreements are considered cash flow 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 effects of derivative instruments on the Consolidated Financial Statements for December 31, 2010 are as follows:

Derivatives at dates shown:

(Dollars in thousands)

| Derivatives designated as hedging instruments | Notional/<br>Contract<br>Amount | Estimated<br>Net Fair<br>Value | December 31, 2010                          |                      | Expiration<br>Date | Fixed Rate |
|---|---------------------------------|--------------------------------|--|----------------------|--------------------|------------|
|   |                                 |                                | Fair Value<br>Balance<br>Sheet<br>Location | Other<br>liabilities |                    |            |
| Interest rate swap - 10 year cash flow        | \$ 4,000                        | \$ 4,019                       |  |                      | 9/15/2020          | 3.21 %     |

| Derivatives in cash flow hedging relationships | December 31, 2010   |   |  |
|--|---|---|--|
|  | Amount of<br>Gain (Loss)<br>Recognized in<br>OCI on<br>Derivatives,<br>net of tax<br>(Effective<br>Portion) | Location of<br>Gain or<br>(Loss)<br>Recognized<br>in Income<br>on<br>Derivative<br>(Ineffective<br>Portion) | Amount of<br>Gain (Loss)<br>Recognized in<br>Income on<br>Derivative<br>(Ineffective<br>Portion) |
| Interest rate swap - 10 year cash flow         | 2010  | Not<br>applicable   | 2010   |
|  | \$ 12   |   | \$ -   |

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Notes to Consolidated Financial Statements

Under the terms of the agreement, the Company receives interest quarterly at the rate equivalent to three month LIBOR repricing every three months on the same date as the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036 and pays interest income monthly at the fixed rate shown above.

The net interest expense on the interest rate swap was \$34,673 for year ended December 31, 2010.

Note 18. Fair Value Measurement

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

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

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

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

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

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

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

Interest rate swap: Cash flow interest rate swap is classified within Level 2 with fair values determined by quoted market prices and mathematical models using current and historical data.

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



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## Notes to Consolidated Financial Statements

|  |           | Fair Value Measurements at Using   |   |  |  |
|--|-----------|--|---|--|--|
| (In Thousands)   |           |  |   |  |  |
| Description  | Balance   | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |  |
| Assets at December 31, 2010                              |           |  |   |  |  |
| Available-for-sale securities:                           |           |  |   |  |  |
| Obligations of U.S. Government corporations and agencies | \$ 40,032 | \$ -   | \$ 40,032   | \$ -   |  |
| Obligations of states and political subdivisions         | 5,619     | -  | 5,619   | -  |  |
| Corporate bonds  | 552       | -  | -   | 552  |  |
| Mutual funds   | 326       | 326  | -   | -  |  |
| FHLMC Preferred  | 9         | -  | 9   | -  |  |
| Total assets at fair value                               | \$ 46,538 | \$ 326   | \$ 45,660   | \$ 552   |  |
| Liabilities at December 31, 2010                         |           |  |   |  |  |
| Interest rate swap                                       | \$ 4,019  | \$ -   | \$ 4,019  | \$ -   |  |
| Total liabilities at fair value                          | \$ 4,019  | \$ -   | \$ 4,019  | \$ -   |  |
| Assets at December 31, 2009                              |           |  |   |  |  |
| Available-for-sale securities:                           |           |  |   |  |  |
| Obligations of U.S. Government corporations and agencies | \$ 28,729 | \$ -   | \$ 28,729   | \$ -   |  |
| Obligations of states and political subdivisions         | 5,724     | -  | 5,724   | -  |  |
| Corporate bonds  | 1,912     | -  | -   | 1,912  |  |
| Mutual funds   | 312       | 312  | -   | -  |  |
| FHLMC Preferred  | 15        | -  | 15  | -  |  |
| Total assets at fair value                               | \$ 36,692 | \$ 312   | \$ 34,468   | \$ 1,912   |  |

## Change in Level 3 Fair Value

The changes in Level 3 assets measured at estimated fair value on a recurring basis during the year ended December 31, 2010 were as follows:

| (In Thousands)                                | Balance<br>January 1,<br>2010 | Total Gains (Losses)<br>Realized/Unrealized |   |   | Balance<br>December 31,<br>2010 |
|---|-------------------------------|---|---|---|---------------------------------|
|   |                               | Included in<br>earnings                     | Included in<br>Other<br>Comprehensive<br>Income | Transfers<br>in and/or<br>out of<br>Level 3 |                                 |
| Description<br>Assets at December 31,<br>2010 |                               |   |   |   |                                 |

Available-for-sale  
securities:

|                 |          |             |       |      |        |
|-----------------|----------|-------------|-------|------|--------|
| Corporate bonds | \$ 1,912 | \$ (1,394 ) | \$ 34 | \$ - | \$ 552 |
|-----------------|----------|-------------|-------|------|--------|

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

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## Notes to Consolidated Financial Statements

Certain assets such as real estate owned are measured at fair value less the estimated cost to sell. Management believes that the fair value component in its valuation follows the provisions of ASC 820.

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

| (In Thousands)<br>Description | Balance as of<br>December 31,<br>2010 | Carrying value at December 31, 2010   |   |  |
|-------------------------------|---------------------------------------|---|---|--|
|                               |                                       | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:                       |                                       |   |   |  |
| Impaired loans, net           | \$ 634                                | -   | \$438   | \$ 196   |
| Other real estate owned       | 2,821                                 | -   | 2,821   | -  |

| (In Thousands)<br>Description | Balance as of<br>December 31,<br>2009 | Carrying value at December 31, 2009   |   |  |
|-------------------------------|---------------------------------------|---|---|--|
|                               |                                       | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:                       |                                       |   |   |  |
| Impaired loans, net           | \$ 2,050                              | -   | \$794   | \$ 1,256   |
| Other real estate owned       | 2,480                                 | -   | 2,480   | -  |

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instruments. ASC 820 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:



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### Notes to Consolidated Financial Statements

#### Cash and cash equivalents

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

#### Securities

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

#### Loan Receivables

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

#### Accrued Interest

The carrying amounts of accrued interest approximate fair value.

#### Deposit Liabilities

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

#### Federal Funds Purchased

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

#### Federal Home Loan Bank Advances

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

#### Off-Balance-Sheet Financial Instruments



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

The fair value of standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

At December 31, 2010 and 2009, the fair value of loan commitments and standby letters of credit were deemed immaterial.

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

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## Notes to Consolidated Financial Statements

| (In Thousands)  | 2010            |            | 2009            |            |
|---|-----------------|------------|-----------------|------------|
|   | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| <b>Financial assets:</b>                                    |                 |            |                 |            |
| Cash and short-term investments                             | \$ 47,171       | \$ 47,171  | \$ 26,199       | \$ 26,199  |
| Federal funds sold  | 11              | 11         | 9               | 9          |
| Securities  | 46,538          | 46,538     | 36,692          | 36,692     |
| Restricted investments                                      | 3,388           | 3,388      | 3,775           | 3,775      |
| Loans, net  | 460,442         | 479,009    | 462,784         | 477,100    |
| Accrued interest receivable                                 | 1,488           | 1,488      | 1,495           | 1,495      |
| <b>Financial liabilities:</b>                               |                 |            |                 |            |
| Deposits  | \$ 520,056      | \$ 524,324 | \$ 465,987      | \$ 467,600 |
| FHLB advances   | 25,000          | 26,247     | 50,000          | 50,477     |
| Company obligated mandatorily redeemable capital securities | 4,124           | 4,696      | 4,124           | 2,673      |
| Interest rate swap  | 4,019           | 4,019      | -               | -          |
| Accrued interest payable                                    | 464             | 464        | 613             | 613        |

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 19.

## Other Operating Expenses

The principal components of "Other operating expenses" in the Consolidated Statements of Income are:

|   | 2010         | 2009         | 2008         |
|---|--------------|--------------|--------------|
| Postage and courier expenses                | \$ 303,645   | \$ 327,493   | \$ 299,035   |
| Paper and supplies                          | 251,895      | 276,828      | 235,370      |
| Taxes, other than income taxes              | 308,221      | 313,183      | 284,676      |
| Charge-offs, other than loan charge-offs    | 388,121      | 489,007      | 350,128      |
| Telephone                                   | 285,843      | 258,011      | 232,416      |
| Directors' compensation                     | 445,678      | 339,613      | 332,143      |
| Other (no items exceed 1% of total revenue) | 1,007,447    | 1,041,759    | 1,060,061    |
|   | \$ 2,990,850 | \$ 3,045,894 | \$ 2,793,829 |

Directors' compensation is allocated and expensed separately at both the Bank and at the parent company. The above year to year comparisons of directors' compensation are on a consolidated basis.

Note 20.

Concentration Risk

The Company maintains its cash accounts in several correspondent banks. The total amount of cash on deposit in those banks did not exceed the federally insured limits at December 31, 2010 and 2009.

Note 21.

Capital Requirements

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

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## Notes to Consolidated Financial Statements

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2010 and 2009, that the Company and the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2010, the most recent notification from the Federal Reserve Bank of Richmond categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Company's and the Bank's actual capital amounts and ratios are also presented in the table. No amount was deducted from capital for interest-rate risk.

| (Dollars In Thousands)                    | Actual   |       | Minimum Capital Requirement |       | Well Capitalized Under Prompt Corrective Action Provisions |          |        |
|---|----------|-------|-----------------------------|-------|--|----------|--------|
|   | Amount   | Ratio | Amount                      | Ratio | Amount   | Ratio    |        |
| As of December 31, 2010:                  |          |       |                             |       |  |          |        |
| Total Capital (to Risk Weighted Assets):  |          |       |                             |       |  |          |        |
| Consolidated                              | \$55,728 | 12.6  | % \$35,535                  | 8.0   | %  | N/A      | N/A    |
| The Fauquier Bank                         | \$54,926 | 12.4  | % \$35,499                  | 8.0   | %  | \$44,374 | 10.0 % |
| Tier 1 Capital (to Risk Weighted Assets): |          |       |                             |       |  |          |        |
| Consolidated                              | \$50,170 | 11.3  | % \$17,765                  | 4.0   | %  | N/A      | N/A    |
| The Fauquier Bank                         | \$49,370 | 11.1  | % \$17,749                  | 4.0   | %  | \$26,624 | 6.0 %  |
| Tier 1 Capital (to Average Assets):       |          |       |                             |       |  |          |        |
| Consolidated                              | \$50,170 | 8.6   | % \$24,362                  | 4.0   | %  | N/A      | N/A    |
| The Fauquier Bank                         | \$49,370 | 8.1   | % \$24,351                  | 4.0   | %  | \$30,438 | 5.0 %  |
| As of December 31, 2009:                  |          |       |                             |       |  |          |        |
| Total Capital (to Risk Weighted Assets):  |          |       |                             |       |  |          |        |
| Consolidated                              | \$54,043 | 12.2  | % \$35,413                  | 8.0   | %  | N/A      | N/A    |
| The Fauquier Bank                         | \$53,930 | 12.1  | % \$35,568                  | 8.0   | %  | \$44,460 | 10.0 % |
| Tier 1 Capital (to Risk Weighted Assets): |          |       |                             |       |  |          |        |
| Consolidated                              | \$48,558 | 11.0  | % \$17,706                  | 4.0   | %  | N/A      | N/A    |
| The Fauquier Bank                         | \$48,445 | 10.9  | % \$17,794                  | 4.0   | %  | \$26,691 | 6.0 %  |
| Tier 1 Capital (to Average Assets):       |          |       |                             |       |  |          |        |
| Consolidated                              | \$48,558 | 8.7   | % \$22,377                  | 4.0   | %  | N/A      | N/A    |
| The Fauquier Bank                         | \$48,445 | 8.7   | % \$22,351                  | 4.0   | %  | \$27,938 | 5.0 %  |



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Notes to Consolidated Financial Statements

Note 22. Company-Obligated Mandatorily Redeemable Capital Securities

On March 26, 2002, the Company established a subsidiary trust that issued \$4.0 million of capital securities as part of a pooled trust preferred security offering with other financial institutions (Trust I). The Company used the offering proceeds for the purposes of expansion and the repurchase of additional shares of its common stock. The interest rate on the capital security resets every three months at 3.60% above the then current three month LIBOR. Interest is paid quarterly.

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.

The purpose of the September 2006 Trust II issuance was to use the proceeds to redeem the existing capital securities of Trust I on March 26, 2008. Because of changes in the market pricing of capital securities from 2002 to 2006, the September 2006 issuance was priced 190 basis points less than that of the March 2002 issuance, and the repayment of the March 2002 issuance in March 2008 reduced the interest expense associated with the distribution on capital securities of subsidiary trust by \$76,000 annually. The Company redeemed all the existing capital securities issued by Trust I on March 26, 2008.

Total capital securities at December 31, 2010 and 2009 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.

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.

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## Notes to Consolidated Financial Statements

## Note 23. Parent Corporation Only Financial Statements

FAUQUIER BANKSHARES, INC.  
(Parent Corporation Only)Balance Sheets  
December 31, 2010 and 2009

| Assets  | December 31, |              |
|---|--------------|--------------|
|   | 2010         | 2009         |
| Cash on deposit with subsidiary bank  | \$434,739    | \$121,140    |
| Interest-bearing deposits at other banks  | 450,000      | -            |
| Investment in subsidiaries, at cost, plus equity in undistributed net income    | 47,292,908   | 46,525,246   |
| Other assets  | 185,153      | 220,920      |
| Total assets  | \$48,362,800 | \$46,867,306 |
| Liabilities and Shareholders' Equity  |              |              |
| Liabilities   |              |              |
| Company-obligated mandatorily redeemable capital securities                     | \$4,124,000  | \$4,124,000  |
| Other liabilities   | 133,237      | 105,464      |
|   | 4,257,237    | 4,229,464    |
| Shareholders' Equity  |              |              |
| Common stock  | 11,277,346   | 11,103,371   |
| Retained earnings, which are substantially distributed earnings of subsidiaries | 34,892,905   | 33,458,933   |
| Accumulated other comprehensive income (loss)                                   | (2,064,688)  | (1,923,462)  |
|   | 44,105,563   | 42,638,842   |
| Total liabilities and shareholders' equity                                      | \$48,362,800 | \$46,868,306 |

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## Notes to Consolidated Financial Statements

FAUQUIER BANKSHARES, INC.  
(Parent Corporation Only)

## Statements of Income

For Each of the Three Years in the Period Ended December 31, 2010

|  | 2010        | December 31,<br>2009 | 2008        |
|--|-------------|----------------------|-------------|
| <b>Revenue</b>   |             |                      |             |
| Interest Income  | \$316       | \$-                  | \$1,153     |
| (Loss) on impairment of securities                               | -           | (112,920 )           |             |
| Dividends from Subsidiaries                                      | 3,315,023   | 2,877,259            | 2,853,779   |
|  | 3,315,339   | 2,764,339            | 2,854,932   |
| <b>Expenses</b>  |             |                      |             |
| Interest expense   | 117,316     | 109,051              | 200,263     |
| Legal and professional fees                                      | 250,805     | 485,506              | 237,552     |
| Directors' fees  | 301,978     | 203,663              | 188,193     |
| Miscellaneous  | 103,807     | 217,658              | 135,306     |
|  | 773,906     | 1,015,878            | 761,314     |
| Income before income tax benefits and equity in                  | 2,541,433   | 1,748,461            | 2,093,618   |
| Income tax benefit   | (205,606 )  | (434,664 )           | (252,862 )  |
| Income before equity in undistributed net income of subsidiaries | 2,747,039   | 2,183,125            | 2,346,480   |
| Equity in undistributed net income of subsidiaries               | 920,277     | 1,234,353            | 1,306,235   |
| Net income   | \$3,667,316 | \$3,417,478          | \$3,652,715 |



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## Notes to Consolidated Financial Statements

FAUQUIER BANKSHARES, INC.  
(Parent Corporation Only)

Statements of Cash Flows  
For Each of the Three Years in the Period Ended December 31, 2010

|   | 2010        | December 31,<br>2009 | 2008        |
|---|-------------|----------------------|-------------|
| <b>Cash Flows from Operating Activities</b>                                       |             |                      |             |
| Net income  | \$3,667,316 | \$3,417,478          | \$3,652,715 |
| Adjustments to reconcile net income to net cash provided by operating activities: |             |                      |             |
| Undistributed earnings of subsidiaries  | (920,277 )  | (1,234,353)          | (1,306,235) |
| Deferred tax benefit  | 131,457     | (50,844 )            | 5,593       |
| Decrease in undistributed dividends receivable from subsidiaries                  |             | -                    | -           |
| Tax benefit of nonqualified options exercised                                     | (54,832 )   | (10,162 )            | (21,783 )   |
| Amortization of unearned compensation   | 246,789     | 208,666              | 263,575     |
| (Increase) decrease in other assets   | (28,469 )   | 481,873              | 131,945     |
| Increase (decrease) in other liabilities  | 27,773      | 37,055               | (7,078 )    |
| Net cash provided by operating activities   | 3,069,757   | 2,849,713            | 2,718,732   |
| <b>Cash Flows from Financing Activities</b>                                       |             |                      |             |
| Proceeds from (repayment of) issuance of capital securities                       | -           | -                    | -           |
| Cash dividends paid   | (2,615,023) | (2,877,259)          | (2,853,779) |
| Issuance of common stock  | 308,865     | 108,202              | 209,304     |
| Acquisition of common stock   | -           | -                    | (155,031 )  |
| Net cash provided by (used in) financing activities                               | (2,306,158) | (2,769,057)          | (2,799,506) |
| Increase (decrease) in cash and cash equivalents                                  | 763,599     | 80,656               | (80,774 )   |
| <b>Cash and Cash Equivalents</b>  |             |                      |             |
| Beginning   | 121,140     | 40,484               | 121,258     |
| Ending  | \$884,739   | \$121,140            | \$40,484    |

Note 23.

## Subsequent Event

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

Based on the evaluation, the Company did not identify any recognized or non-recognized subsequent events that would have required adjustment to, or disclosure in, the financial statements.



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ITEM CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND  
9. FINANCIAL DISCLOSURE

None.

ITEM 9A. 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 Exchange Act is recorded, processed, summarized, and reported within the time periods required by the Securities and Exchange Commission. An evaluation of the effectiveness of the design and operations of the Company's disclosure controls and procedures at the end of the period covered by this report was carried out under the supervision and with the participation of the management of Fauquier Bankshares, Inc., including the Chief Executive Officer and the Chief Financial Officer. Based on such an evaluation, the Chief Executive Officer and the Chief Financial Officer concluded the Company's disclosure controls and procedures were effective as of the end of such period.

Management's Report on Internal Control Over Financial Reporting

Fauquier Bankshares, Inc. is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements and notes included in this annual report have been prepared in conformity with United States generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgments.

We, as management of Fauquier Bankshares, Inc., are responsible for establishing and maintaining effective internal control over financial reporting that is designed to produce reliable financial statements in conformity with United States generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company; provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles; provide a reasonable assurance that receipts and expenditures of the company are only being made in accordance with authorizations of management and directors of the Company; and provide a reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements. The system of internal control over financial reporting as it relates to the financial statements is evaluated for effectiveness by management and tested for reliability through a program of internal audits. Actions are taken to correct potential deficiencies as they are noted.

Any system of internal control, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation.

Management assessed the Company's system of internal control over financial reporting as of December 31, 2010, in relation to the criteria for effective control over financial reporting as described in "Internal Control – Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concludes that, as of December 31, 2010, its system of internal control over financial reporting is effective and meets the criteria of the "Internal Control – Integrated Framework."

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report is not subject to attestation by the Company's independent registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this Annual Report.

No changes were made in Management's internal control over financial reporting during the year ended December 31, 2010 that have materially affected, or that are reasonably likely to materially affect, Management's internal control over financial reporting.

ITEM 9B.

OTHER INFORMATION

None.

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## PART III

## ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information concerning the Company required by this item is contained in the Company's definitive proxy statement for the 2011 annual meeting of shareholders to be held on May 17, 2011 (the "2011 proxy statement") under the captions "Election of Class III Directors," "Meetings and Committees of the Board of Directors," and "Section 16(a) Beneficial Ownership Reporting Compliance," and is incorporated herein by reference.

The Company has adopted a Code of Business Conduct and Ethics that applies to the directors, executive officers and employees of the Company and the Bank. Please see Exhibit 14 in the exhibit list contained in Part IV, Item 14 of this Form 10-K.

## ITEM 11. EXECUTIVE COMPENSATION

The information relating to executive and director compensation is contained in the Company's 2011 proxy statement under the captions "Directors' Compensation" and "Executive Compensation" and is incorporated herein by reference.

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information regarding security ownership required by this item is contained in the Company's 2011 proxy statement under the caption "Security Ownership of Certain Beneficial Owners and Management," and is incorporated herein by reference.

The following table sets forth information as of December 31, 2010 with respect to compensation plans under which equity securities of the Company are authorized for issuance:

## Equity Compensation Plan Information

| Plan Category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights<br>(a) | Weighted -average exercise price of outstanding options, warrants and rights<br>(b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))<br>(c) |
|--|--|---|--|
| Equity compensation plans approved by security holders     | 42,268 (1)   | \$ 10.84  | 318,357 (2)  |
| Equity compensation plans not approved by security holders | -  | -   | -  |
| Total  | 42,268   | \$ 10.84  | 318,357  |

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(1) Consists of shares underlying options that were granted under the Company's Omnibus Stock Ownership and Long Term Incentive Plan, which expired December 31, 2009.

(2) Consists of 350,000 shares available to be granted in the form of options, restricted stock or stock appreciation rights under the Stock Incentive Plan approved by security holders on May 19, 2009.

For additional information concerning the material features of the Company's equity compensation plans please see Note 13 of our Notes to Consolidated Financial Statements.

#### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required by this item is contained in the Company's 2011 proxy statement under the captions "Meetings and Committees of the Board of Directors" and "Related Party Transactions," and is incorporated herein by reference.

#### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information required by this item is contained in the Company's 2011 proxy statement under the captions "Principal Accountant Fees" and "Pre-Approval Policies," and is incorporated herein by reference.

#### PART IV

#### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

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(a) (1) -Financial Statements

The following consolidated financial statements of Fauquier Bankshares, Inc. and subsidiaries are filed as part of this document under Item 7. Financial Statements and Supplementary Data.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets - December 31, 2010 and December 31, 2009

Consolidated Statements of Income -Years ended December 31, 2010, 2009, and 2008

Consolidated Statements of Cash Flows -Years ended December 31, 2010, 2009, and 2008

Consolidated Statements of Changes in Shareholders' Equity - December 31, 2010, 2009, and 2008

Notes to Consolidated Financial Statements -Years ended December 31, 2010, 2009, and 2008

(a) (2) -Financial Statement Schedules

All schedules to the consolidated financial statements required by Article 9 of Regulation S-X are omitted since they are either not applicable or the required information is set forth in the consolidated financial statements or notes thereto.

(a) (3) -Exhibits

The following exhibits are filed as part of this Form 10-K and this list includes the Exhibit Index.

| Exhibit Number | Exhibit Description |
|----------------|---------------------|
|----------------|---------------------|

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

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

Certain instruments relating to capital securities not being registered have been omitted in accordance with Item 601(b)(4)(iii) of Regulation S-K. The registrant will furnish a copy of any such instrument to the Securities and Exchange Commission upon its request.

|      |   |
|------|---|
| 10.1 | Fauquier Bankshares, Inc. Omnibus Stock Ownership and Long Term Incentive Plan, as amended and restated effective January 1, 2000, incorporated by reference to Exhibit 4.B to Form S-8 filed October 15, 2002. |
|------|---|

|        |   |
|--------|---|
| 10.1.1 | Form of Restricted Stock Grant Agreement for Employee, incorporated by reference to Exhibit 10.1.1 to Form 8-K filed February 16, 2005. |
|--------|---|

|        |  |
|--------|--|
| 10.1.2 | Form of Restricted Stock Grant Agreement for Non-Employee Director, incorporated by reference to Exhibit 10.1.2 to Form 8-K filed February 16, 2005. |
|--------|--|

|      |   |
|------|---|
| 10.2 | Fauquier Bankshares, Inc. Director Deferred Compensation Plan, as adopted effective May 1, 1995, incorporated by reference to Exhibit 4.C to Form S-8 filed October 15, 2002. |
|------|---|

|      |   |
|------|---|
| 10.3 | Fauquier Bankshares, Inc. Stock Incentive Plan, incorporated by reference to Exhibit 99.1 to Form S-3 filed August 21, 2009 |
|------|---|

- 10.3.1 Form of Incentive Stock Option Agreement relating to Fauquier Bankshares, Inc. Stock Incentive Plan, incorporated by reference to Exhibit 10.4.1 to Form 8-K filed March 15, 2010.
- 10.3.2 Form of Nonstatutory Stock Option Agreement relating to Fauquier Bankshares, Inc. Stock Incentive Plan, incorporated by reference to Exhibit 10.4.1 to Form 8-K filed March 15, 2010.



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|             |  |
|-------------|--|
| 10.3.3      | Form of Restricted Stock Awards Agreement relating to Fauquier Bankshares, Inc. Stock Incentive Plan, incorporated by reference to Exhibit 10.4.1 to Form 8-K filed March 15, 2010.  |
| 10.4        | Change of Control Agreement, dated November 27, 2000, between Fauquier Bankshares, Inc. and Eric P. Graap, incorporated by reference to Exhibit 10.8 to Form 10-K filed March 25, 2003.  |
| 10.4.1      | First Amendment, dated December 31, 2008, to Change of Control Agreement, dated November 27, 2000, between Fauquier Bankshares, Inc. and Eric P. Graap, incorporated by reference to Exhibit 10.4.1 to Form 10-K filed March 16, 2009.   |
| 10.5        | Form of the Executive Survivor Income Agreement, dated on or about May 9, 2003, between The Fauquier Bank and each of Randy K. Ferrell and Eric P. Graap, incorporated by reference to Exhibit 10.13 to Form 10-Q filed August 14, 2003. |
| 10.6        | Employment Agreement, dated January 19, 2005, between Fauquier Bankshares, Inc., The Fauquier Bank and Randy K. Ferrell, incorporated by reference to Exhibit 10.14 to Form 10-K filed March 30, 2005.                                   |
| 10.6.1      | First Amendment, dated March 26, 2008, to Employment Agreement, dated January 19, 2005, between Fauquier Bankshares, Inc., The Fauquier Bank and Randy K. Ferrell.   |
| 10.7        | Fauquier Bankshares, Inc. Supplemental Executive Retirement Plan, as amended and restated October 21, 2010, incorporated by reference to Exhibit 10.15 to Form 10-Q filed November 8, 2010.  |
| 10.7.1      | Form of Participation Agreement for Fauquier Bankshares, Inc. Supplemental Executive Retirement Plan, incorporated by reference to Exhibit 10.15.1 to Form 10-Q filed November 8, 2010.  |
| <u>10.8</u> | Base Salaries for Named Executive Officers.  |
| 14          | Code of Business Conduct and Ethics, incorporated by reference to Exhibit 14 to Form 10-Q filed August 11, 2006.   |
| 21          | Subsidiaries of the Fauquier Bankshares, Inc., incorporated herein by reference to Part I of this Form 10-K.   |
| <u>23.1</u> | Consent of Smith Elliott Kearns & Company, LLC.  |
| <u>31.1</u> | Certification of CEO pursuant to Rule 13a-14(a).   |
| <u>31.2</u> | Certification of CFO pursuant to Rule 13a-14(a).   |
| <u>32.1</u> | Certification of CEO pursuant to 18 U.S.C. Section 1350.   |
| <u>32.2</u> | Certification of CFO pursuant to 18 U.S.C. Section 1350.   |

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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: March 11, 2011

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/s/ Eric P. Graap  
 Eric P. Graap  
 Executive Vice President & Chief Financial Officer  
 Dated: March 11, 2011

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| SIGNATURE  | TITLE  | DATE           |
|--|--|----------------|
| /s/ John B. Adams, Jr.<br>John B. Adams, Jr            | Chairman, Director   | March 11, 2011 |
| /s/ Randy K. Ferrell<br>Randy K. Ferrell               | President & Chief Executive Officer,<br>Director<br>(principal executive officer)                                  | March 11, 2011 |
| /s/ Eric P. Graap<br>Eric P. Graap                     | Executive Vice President & Chief<br>Financial Officer, Director<br>(principal financial and accounting<br>officer) | March 11, 2011 |
| /s/ Randolph T. Minter<br>Randolph T. Minter           | Vice Chairman, Director  | March 11, 2011 |
| /s/ Randolph D. Frostick<br>Randolph D. Frostick       | Director   | March 11, 2011 |
| /s/ Douglas C. Larson<br>Douglas C. Larson             | Director   | March 11, 2011 |
| /s/ Jay B. Keyser<br>Jay B. Keyser                     | Director   | March 11, 2011 |
| /s/ Brian.S. Montgomery<br>Brian.S. Montgomery         | Director   | March 11, 2011 |
| /s/ P. Kurt Rodgers<br>P. Kurt Rodgers                 | Director   | March 11, 2011 |
| /s/ Sterling T. Strange III<br>Sterling T. Strange III | Director   | March 11, 2011 |