

FAUQUIER BANKSHARES, INC.

Form 10-Q

November 09, 2009

Table of Contents

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

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2009**

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

(State or other jurisdiction of
incorporation or organization)

54-1288193

(I.R.S. Employer Identification No.)

10 Courthouse Square, Warrenton, Virginia

(Address of principal executive offices)

20186

(Zip Code)

(540) 347-2700

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

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

Yes No

The registrant had 3,598,537 shares of common stock outstanding as of November 5, 2009.

FAUQUIER BANKSHARES, INC.
INDEX

| | Page |
|---|------|
| <u>Part I. FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements</u> | |
| <u>Consolidated Balance Sheets as of September 30, 2009 (unaudited) and December 31, 2008</u> | 3 |
| <u>Consolidated Statements of Income (unaudited) for the Three Months Ended September 30, 2009 and 2008</u> | 4 |
| <u>Consolidated Statements of Income (unaudited) for the Nine Months Ended September 30, 2009 and 2008</u> | 5 |
| <u>Consolidated Statements of Changes in Shareholders' Equity (unaudited) for the Nine Months Ended September 30, 2009 and 2008</u> | 6 |
| <u>Consolidated Statements of Cash Flows (unaudited) for the Nine Months Ended September 30, 2009 and 2008</u> | 7 |
| <u>Notes to Consolidated Financial Statements</u> | 8 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 19 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u> | 41 |
| <u>Item 4. Controls and Procedures</u> | 41 |
| <u>Part II. OTHER INFORMATION</u> | 42 |
| <u>Item 1. Legal Proceedings</u> | 42 |
| <u>Item 1A. Risk Factors</u> | 42 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 42 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 42 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 42 |
| <u>Item 5. Other Information</u> | 42 |
| <u>Item 6. Exhibits</u> | 42 |
| <u>SIGNATURES</u> | 43 |
| <u>EX-31.1</u> | |
| <u>EX-31.2</u> | |
| <u>EX-32.1</u> | |
| <u>EX-32.2</u> | |

Table of Contents**Part I. FINANCIAL INFORMATION**

ITEM 1. FINANCIAL STATEMENTS

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Balance Sheets

| | September 30, 2009 (Unaudited) | December 31, 2008 (Audited) |
|--|---|--|
| Assets | | |
| Cash and due from banks | \$ 5,491,989 | \$ 7,698,661 |
| Interest-bearing deposits in other banks | 14,964,633 | 3,324,501 |
| Federal funds sold | 10,340 | |
| Securities available for sale | 38,275,106 | 37,839,375 |
| Loans, net of allowance for loan losses of \$5,221,035 in 2009 and \$4,779,662 in 2008 | 455,391,125 | 434,678,433 |
| Bank premises and equipment, net | 12,827,259 | 8,621,217 |
| Accrued interest receivable | 1,462,759 | 1,549,597 |
| Other real estate owned | 2,029,085 | 3,034,470 |
| Other assets | 17,931,939 | 17,768,978 |
| Total assets | \$ 548,384,235 | \$ 514,515,232 |
| Liabilities and Shareholders Equity | | |
| Deposits: | | |
| Noninterest-bearing | 64,347,781 | 69,065,944 |
| Interest-bearing: | | |
| NOW accounts | 81,296,578 | 74,555,901 |
| Savings and money market accounts | 102,924,321 | 102,810,758 |
| Time certificates of deposit | 186,998,679 | 153,861,028 |
| Total interest-bearing | 371,219,578 | 331,227,687 |
| Total deposits | 435,567,359 | 400,293,631 |
| Federal funds purchased | 10,000,000 | 18,275,000 |
| Federal Home Loan Bank advances | 50,000,000 | 45,000,000 |
| Company-obligated mandatorily redeemable capital securities | 4,124,000 | 4,124,000 |
| Other liabilities | 6,091,826 | 5,334,664 |
| Commitments and contingencies | | |
| Total liabilities | 505,783,185 | 473,027,295 |
| Shareholders Equity | | |
| Common stock, par value, \$3.13; authorized 8,000,000 shares: issued and outstanding, 2009: 3,598,537 shares (includes nonvested shares of 51,134); 2008: 3,564,317 shares (includes nonvested shares of 38,219) | 11,103,371 | 11,036,687 |
| Retained earnings | 33,362,931 | 32,668,530 |
| Accumulated other comprehensive income (loss), net | (1,865,252) | (2,217,280) |
| Total shareholders equity | 42,601,050 | 41,487,937 |

| | | |
|--|----------------|----------------|
| Total liabilities and shareholders' equity | \$ 548,384,235 | \$ 514,515,232 |
|--|----------------|----------------|

See accompanying Notes to Consolidated Financial Statements.

3

Table of Contents**Fauquier Bankshares, Inc. and Subsidiaries****Consolidated Statements of Income****(Unaudited)****For the Three Months Ended September 30, 2009 and 2008**

| | 2009 | 2008 |
|--|---------------|---------------|
| Interest Income | | |
| Interest and fees on loans | \$ 6,698,083 | \$ 6,768,554 |
| Interest and dividends on securities available for sale: | | |
| Taxable interest income | 307,862 | 366,630 |
| Interest income exempt from federal income taxes | 59,374 | 58,289 |
| Dividends | 22,291 | 59,978 |
| Interest on federal funds sold | 38 | 3 |
| Interest on deposits in other banks | 4,511 | 15,305 |
| Total interest income | 7,092,159 | 7,268,759 |
| Interest Expense | | |
| Interest on deposits | 1,310,379 | 1,761,639 |
| Interest on federal funds purchased | 15,698 | 23,877 |
| Interest on Federal Home Loan Bank advances | 274,382 | 519,870 |
| Distribution on capital securities of subsidiary trusts | 23,483 | 45,757 |
| Total interest expense | 1,623,942 | 2,351,143 |
| Net interest income | 5,468,217 | 4,917,616 |
| Provision for loan losses | 360,000 | 431,000 |
| Net interest income after provision for loan losses | 5,108,217 | 4,486,616 |
| Other Income | | |
| Wealth management income | 317,811 | 324,890 |
| Service charges on deposit accounts | 700,521 | 722,065 |
| Other service charges, commissions and income | 419,256 | 436,889 |
| (Loss) on impairment of securities | (245,741) | (297,500) |
| (Loss) on sale of other real estate owned | | (3,000) |
| Total other income | 1,191,847 | 1,183,344 |
| Other Expenses | | |
| Salaries and benefits | 2,677,232 | 2,141,693 |
| Net occupancy expense of premises | 387,895 | 328,600 |

Edgar Filing: FAUQUIER BANKSHARES, INC. - Form 10-Q

| | | |
|--|------------|------------|
| Furniture and equipment | 259,107 | 313,889 |
| Marketing expense | 184,127 | 142,873 |
| Legal, audit, and consulting expense | 220,023 | 261,178 |
| Data processing expense | 232,563 | 325,227 |
| Federal Deposit Insurance Corporation assessment | 145,050 | 64,174 |
| Other operating expenses | 915,151 | 678,431 |
| Total other expenses | 5,021,148 | 4,256,065 |
| Income before income taxes | 1,278,916 | 1,413,895 |
| Income tax expense | 322,982 | 478,892 |
| Net Income | \$ 955,934 | \$ 935,003 |
| Earnings per Share, basic | \$ 0.27 | \$ 0.26 |
| Earnings per Share, assuming dilution | \$ 0.26 | \$ 0.26 |
| Dividends per Share | \$ 0.20 | \$ 0.20 |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**Fauquier Bankshares, Inc. and Subsidiaries****Consolidated Statements of Income****(Unaudited)****For the Nine Months Ended September 30, 2009 and 2008**

| | 2009 | 2008 |
|--|----------------|----------------|
| Interest Income | | |
| Interest and fees on loans | \$ 19,587,882 | \$ 20,292,584 |
| Interest and dividends on securities available for sale: | | |
| Taxable interest income | 980,004 | 1,028,308 |
| Interest income exempt from federal income taxes | 178,759 | 174,700 |
| Dividends | 42,519 | 183,098 |
| Interest on federal funds sold | 194 | 33,296 |
| Interest on deposits in other banks | 11,488 | 27,851 |
| Total interest income | 20,800,846 | 21,739,837 |
| Interest Expense | | |
| Interest on deposits | 4,310,152 | 5,485,364 |
| Interest on federal funds purchased | 38,544 | 87,236 |
| Interest on Federal Home Loan Bank advances | 770,743 | 1,401,345 |
| Distribution on capital securities of subsidiary trusts | 88,703 | 155,462 |
| Total interest expense | 5,208,142 | 7,129,407 |
| Net interest income | 15,592,704 | 14,610,430 |
| Provision for loan losses | 920,000 | 1,721,000 |
| Net interest income after provision for loan losses | 14,672,704 | 12,889,430 |
| Other Income | | |
| Wealth management income | 814,855 | 1,000,127 |
| Service charges on deposit accounts | 2,026,642 | 2,098,330 |
| Other service charges, commissions and income | 1,212,112 | 1,478,325 |
| Gain on sale of securities | | 87,585 |
| (Loss) on impairment of securities | (412,129) | (422,500) |
| Gain (Loss) on sale of other real estate owned | (135,759) | 25,718 |
| Total other income | 3,505,721 | 4,267,585 |
| Other Expenses | | |
| Salaries and benefits | 7,362,842 | 6,768,719 |

Edgar Filing: FAUQUIER BANKSHARES, INC. - Form 10-Q

| | | |
|---|------------------|------------------|
| Net occupancy expense of premises | 1,013,204 | 958,926 |
| Furniture and equipment | 808,388 | 885,431 |
| Advertising expense | 492,485 | 468,469 |
| Legal, audit, and consulting expense | 1,032,927 | 802,566 |
| Data processing expense | 906,487 | 987,569 |
| Federal Deposit Insurance Corporation assessment | 675,150 | 86,903 |
| Other operating expenses | 2,347,868 | 2,088,464 |
| Total other expenses | 14,639,351 | 13,047,047 |
| Income before income taxes | 3,539,074 | 4,109,968 |
| Income tax expense | 936,550 | 1,224,045 |
| Net Income | \$ 2,602,524 | \$ 2,885,923 |
| Earnings per Share , basic | \$ 0.72 | \$ 0.82 |
| Earnings per Share , assuming dilution | \$ 0.72 | \$ 0.81 |
| Dividends per Share | \$ 0.60 | \$ 0.60 |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**Fauquier Bankshares, Inc. and Subsidiaries****Consolidated Statements of Changes in Shareholders' Equity
For the Nine Months Ended September 30, 2009 and 2008**

| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Comprehensive Income | Total |
|--|-----------------|----------------------|---|-------------------------|---------------|
| Balance, December 31, 2007 | \$ 10,974,293 | \$ 31,626,627 | \$ (773,168) | | \$ 41,827,752 |
| Comprehensive income: | | | | | |
| Net income | | 2,885,923 | | \$ 2,885,923 | 2,885,923 |
| Other comprehensive income net of tax: | | | | | |
| Unrealized holding gains (losses) on securities available for sale, net of tax benefit of \$1,145,186 | | | | (2,523,548) | |
| Add: reclassification adjustments, net of tax benefit of \$12,721 | | | | 322,194 | |
| Other comprehensive income (loss) net of tax of \$1,132,465 | | | (2,201,354) | (2,201,354) | (2,201,354) |
| Total comprehensive income | | | | \$ 684,569 | |
| Effects of changing pension plan measurement date, pursuant to FAS 158, net of deferred income tax benefit of \$12,437 | | (24,144) | | | (24,144) |
| Initial implementation of EITF 06-4, net of income tax benefit of \$6,433 | | (12,487) | | | (12,487) |
| Cash dividends (\$.60 per share) | | (2,140,915) | | | (2,140,915) |
| Acquisition of 7,332 shares of common stock | (22,949) | (103,123) | | | (126,072) |
| Amortization of unearned compensation, restricted stock awards | | 244,227 | | | 244,227 |
| 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 | 128,300 | | | 187,520 |

| | | | | |
|---|---------------|---------------|----------------|---------------|
| Balance, September 30, 2008 | \$ 11,042,850 | \$ 32,522,518 | \$ (2,974,522) | \$ 40,590,846 |
| Balance, December 31, 2008 | \$ 11,036,687 | \$ 32,668,530 | \$ (2,217,280) | \$ 41,487,937 |
| Comprehensive income: | | | | |
| Net income | | 2,602,524 | | 2,602,524 |
| Other comprehensive income net of tax: | | | | |
| Unrealized holding gains on securities available for sale, net of tax of \$21,446 | | | | 41,630 |
| Add: reclassification adjustments, net of tax benefit of \$101,731 | | | | 310,398 |
| Other comprehensive income net of tax of \$123,177 | | | 352,028 | 352,028 |
| Total comprehensive income | | | | 2,954,552 |
| Cash dividends (\$.60 per share) | | (2,158,322) | | (2,158,322) |
| Amortization of unearned compensation, restricted stock awards | | 218,843 | | 218,843 |
| Issuance of common stock nonvested shares (10,585 shares) | 33,131 | (33,131) | | |
| Exercise of stock options | 33,553 | 64,487 | | 98,040 |
| Balance, September 30, 2009 | \$ 11,103,371 | \$ 33,362,931 | \$ (1,865,252) | \$ 42,601,050 |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**Fauquier Bankshares, Inc. and Subsidiaries**

Consolidated Statements of Cash Flows
For the Nine Months Ended September 30, 2009 and 2008
(Unaudited)

| | 2009 | 2008 |
|---|---------------|--------------|
| Cash Flows from Operating Activities | | |
| Net income | \$ 2,602,524 | \$ 2,885,923 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 602,622 | 696,976 |
| Provision for loan losses | 920,000 | 1,721,000 |
| Loss (gain) on sale of other real estate | 135,759 | (25,718) |
| Loss on impairment of securities | 412,129 | 422,500 |
| (Gain) on sale of securities | | (87,585) |
| Amortization (accretion) of security premiums, net | (32,079) | (7,486) |
| Amortization of unearned compensation, net of forfeiture | 218,843 | 194,623 |
| Changes in assets and liabilities: | | |
| (Increase) in other assets | (257,471) | (315,556) |
| (Decrease) increase in other liabilities | 757,163 | (19,209) |
| Net cash provided by operating activities | 5,359,490 | 5,465,468 |
| Cash Flows from Investing Activities | | |
| Proceeds from sale of securities available for sale | | 9,078,470 |
| Proceeds from maturities, calls and principal payments of securities available for sale | 7,127,108 | 3,710,672 |
| Purchase of securities available for sale | (6,689,614) | (13,965,595) |
| Purchase of premises and equipment | (4,808,664) | (1,848,458) |
| (Purchase) of other bank stock | (719,900) | (392,300) |
| Net (increase) in loans | (21,632,692) | (16,375,094) |
| Proceeds from sale of other real estate owned | 869,626 | 710,083 |
| Net cash (used in) investing activities | (25,854,136) | (19,082,222) |
| Cash Flows from Financing Activities | | |
| Net increase (decrease) in demand deposits, NOW accounts and savings accounts | 2,136,077 | (35,735,451) |
| Net increase in certificates of deposit | 33,137,651 | 36,799,720 |
| Federal Home Loan Bank advances | 170,000,000 | 70,000,000 |
| Federal Home Loan Bank principal repayments | (165,000,000) | (60,000,000) |
| (Repayment) of federal funds, net | (8,275,000) | |
| Cash dividends paid on common stock | (2,158,322) | (2,140,915) |
| Issuance of common stock | 98,040 | 187,520 |
| Acquisition of common stock | | (126,072) |

Edgar Filing: FAUQUIER BANKSHARES, INC. - Form 10-Q

| | | |
|--|---------------|---------------|
| Net cash provided by financing activities | 29,938,446 | 8,984,802 |
| Increase (decrease) in cash and cash equivalents | 9,443,800 | (4,631,952) |
| Cash and Cash Equivalents | | |
| Beginning | 11,023,162 | 19,552,174 |
| Ending | \$ 20,466,962 | \$ 14,920,222 |

Supplemental Disclosures of Cash Flow Information

| | | |
|--------------------|--------------|--------------|
| Cash payments for: | | |
| Interest | \$ 5,419,609 | \$ 7,262,818 |
| Income taxes | \$ 1,106,000 | \$ 941,000 |

Supplemental Disclosures of Noncash Investing Activities

| | | |
|--|-----------|----------------|
| Unrealized gain (loss) on securities available for sale, net of tax effect | \$ 41,630 | \$ (2,523,548) |
| FAS 158 Pension Liability Implementation Adjustment, net of tax effect | \$ | \$ (24,144) |
| Implementation of EITF 06-4, net of tax effect | \$ | \$ (12,487) |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**FAUQUIER BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****Note 1. General**

The consolidated statements include the accounts of Fauquier Bankshares, Inc. (the Company) and its wholly-owned subsidiaries: The Fauquier Bank (the Bank) and Fauquier Statutory Trust II; and the Bank s wholly-owned subsidiary, Fauquier Bank Services, Inc. In consolidation, significant intercompany financial balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial positions as of September 30, 2009 and December 31, 2008 and the results of operations for the three and nine months ended September 30, 2009 and 2008. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The results of operations for the three and nine months ended September 30, 2009 are not necessarily indicative of the results expected for the full year.

Note 2. Securities

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|--|---------------------------|---------------------------------------|--|-----------------------|
| | | September 30, 2009 | | |
| Obligations of U.S. Government corporations and agencies | \$ 24,803,452 | \$ 963,654 | \$ | \$ 25,767,106 |
| Obligations of states and political subdivisions | 5,569,506 | 199,372 | (6,352) | 5,762,526 |
| Corporate Bonds | 5,700,791 | | (3,070,244) | 2,630,547 |
| Mutual Funds | 312,786 | 941 | | 313,727 |
| FHLMC Preferred Bank Stock | 18,500 | 8,000 | | 26,500 |
| 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 |
| | \$ 40,179,735 | \$ 1,171,967 | \$ (3,076,596) | \$ 38,275,106 |

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|--|---------------------------|---------------------------------------|--|-----------------------|
| | | December 31, 2008 | | |
| Obligations of U.S. Government corporations and agencies | \$ 25,212,561 | \$ 561,884 | \$ (2,030) | \$ 25,772,415 |
| Obligations of states and political subdivisions | 5,574,709 | 29,033 | (146,019) | 5,457,723 |
| Corporate Bonds | 6,000,000 | | (2,861,903) | 3,138,097 |
| Mutual Funds | 303,889 | | (5,969) | 297,920 |
| FHLMC Preferred Bank Stock | 18,500 | | (13,000) | 5,500 |
| Restricted investments: | | | | |
| Federal Home Loan Bank Stock | 2,905,800 | | | 2,905,800 |
| Federal Reserve Bank Stock | 99,000 | | | 99,000 |

Edgar Filing: FAUQUIER BANKSHARES, INC. - Form 10-Q

| | | | | |
|------------------------------|---------------|------------|----------------|---------------|
| Community Bankers Bank Stock | 50,000 | | | 50,000 |
| Silverton Bank Stock | 112,920 | | | 112,920 |
| | \$ 40,277,379 | \$ 590,917 | \$ (3,028,921) | \$ 37,839,375 |

Table of Contents

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.

| | September 30, 2009 | |
|--|--------------------|---------------|
| | Amortized Cost | Fair Value |
| Due in one year or less | \$ 466,740 | \$ 472,063 |
| Due after one year through five years | 163,128 | 168,412 |
| Due after five years through ten years | 9,388,373 | 9,748,445 |
| Due after ten years | 26,055,508 | 23,771,259 |
| Equity securities | 4,105,986 | 4,114,927 |
| | \$ 40,179,735 | \$ 38,275,106 |

During the three and nine months ended September 30, 2009, the Company recognized a permanent impairment of \$245,741 and \$299,209, respectively, on its investment in pooled trust preferred securities. A tax benefit of \$83,552 and \$101,731, respectively, has been recognized on these impairment losses for the same three and nine month periods. In addition, during the nine months ended September 30, 2009, the Company recognized a permanent impairment of \$112,920 on its 50 shares of Silverton Bank common stock. No tax benefit has been recognized on this impairment loss.

During the three and nine months ended September 30, 2008, the Bank recognized permanent impairment losses of \$297,500 and \$422,500, respectively, on its 10,000 shares of Freddie Mac preferred stock.

There were no securities sold in the three and nine months ended September 30, 2009, or for the three months ended September 30, 2008. For the nine months ended September 30, 2008, gross realized gains from sales of securities available for sale amounted to \$87,585. The proceeds from the sale of these securities, including the realized gain, amounted to \$9.1 million. The tax expense applicable to this net realized gain amounted to \$29,779.

The following table shows the Company securities with gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2009 and December 31, 2008, respectively.

| September 30, 2009 | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|---------------------|-------------------|---------------------|------------|---------------------|
| | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) |
| Description of Securities | | | | | | |
| Obligations of U.S. Government, corporations and agencies | \$ | \$ | \$ | \$ | \$ | \$ |
| Obligations of states and political subdivisions | | | 277,675 | (6,352) | 277,675 | (6,352) |
| Corporate Bonds | | | 2,630,547 | (3,070,244) | 2,630,547 | (3,070,244) |
| Subtotal, debt securities | | | 2,908,222 | (3,076,596) | 2,908,222 | (3,076,596) |
| Mutual Funds | | | | | | |
| FHLMC Preferred Bank Stock | | | | | | |

| | | | | | | |
|-------------------------------------|----|----|--------------|----------------|--------------|----------------|
| Total temporary impaired securities | \$ | \$ | \$ 2,908,222 | \$ (3,076,596) | \$ 2,908,222 | \$ (3,076,596) |
|-------------------------------------|----|----|--------------|----------------|--------------|----------------|

| December 31, 2008 Description of Securities | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|------------------------|-------------------|------------------------|--------------|------------------------|
| | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) |
| Obligations of U.S. Government, corporations and agencies | \$ 785,744 | \$ (2,030) | \$ | \$ | 785,744 | \$ (2,030) |
| Obligations of states and political subdivisions | 4,181,657 | (146,019) | | | 4,181,657 | (146,019) |
| Corporate Bonds | | | 3,138,097 | (2,861,903) | 3,138,097 | (2,861,903) |
| Subtotal, debt securities | 4,967,401 | (148,049) | 3,138,097 | (2,861,903) | 8,105,498 | (3,009,952) |
| Mutual Funds | | | 297,920 | (5,969) | 297,920 | (5,969) |
| FHLMC Preferred Bank Stock | 5,500 | (13,000) | | | 5,500 | (13,000) |
| Total temporary impaired securities | \$ 4,972,901 | \$ (161,049) | \$ 3,436,017 | \$ (2,867,872) | \$ 8,408,918 | \$ (3,028,921) |

The nature of securities which are temporarily impaired for a continuous 12 month period or more at September

Table of Contents

30, 2009 can be segregated into two groups:

The first group consists of four corporate bonds with a cost basis totaling \$5.7 million and a temporary loss of approximately \$3.1 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. 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. They have an estimated maturity of 26 years, but can be called at par on the five year anniversary date of issuance, which has already passed for all four bonds. If not called, the bonds reprice every three months at a fixed rate index above the three-month London Interbank Offered Rate (LIBOR). These bonds have sufficient collateralization and cash flow projections to satisfy their valuation based on the cash flow portion of the Other Than Temporary Impairment (OTTI) test under authoritative accounting guidance as of September 30, 2009. Two of the bonds totaling \$1,996,221, at fair value, are current, and two bonds totaling \$634,326 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 September 30, 2009 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 | Current Moody's Rating | Estimate in amount of additional deferrals/defaults before temporary or permanent shortfall in cash flow |
|------------------------|------------|---|--|---|------------------------|--|
| \$ 798,082 | 296,704 | 71.1% | 20.6% | 8.3% | Ca | 0.0% |
| 2,000,000 | 962,903 | 82.2% | 9.5% | 8.3% | Ca | 6.1% |
| 2,000,000 | 1,033,318 | 84.9% | 13.4% | 1.7% | Ca | 3.0% |
| 902,709 | 337,622 | 78.0% | 10.7% | 11.3% | Ca | 0.0% |

The second group consists of one municipal bond totaling \$277,675 with a temporary loss of \$6,352. This bond is current. The Company plans to hold it until maturity in 2020.

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$22.1 million and \$25.9 million at September 30, 2009 and December 31, 2008, respectively.

Note 3. Loans

A summary of the balances of loans follows:

| | September 30, 2009 | December 31, 2008 |
|--|--------------------|-------------------|
| | (Thousands) | |
| Real estate loans: | | |
| Construction | \$ 38,223 | \$ 38,037 |
| Secured by farmland | 950 | 1,293 |
| Secured by 1 - to - 4 family residential | 187,852 | 175,791 |
| Other real estate loans | 183,431 | 160,443 |
| Commercial and industrial loans (not secured by real estate) | 37,954 | 39,985 |
| Consumer installment loans | 11,632 | 15,695 |
| All other loans | 776 | 8,934 |

| | | |
|---------------------------|------------|------------|
| Total loans | \$ 460,818 | \$ 440,178 |
| Unearned income | (206) | (720) |
| Allowance for loan losses | (5,221) | (4,780) |
| Net loans | \$ 455,391 | \$ 434,678 |

Table of Contents

Of the \$183.4 million in other real estate loans at September 30, 2009, \$103.7 million were owner occupied. Of the \$160.4 million in other real estate loans at December 31, 2008, \$96.2 million were owner occupied.

Note 4. Allowance for Loan Losses

Analysis of the allowance for loan losses follows:

| | Nine Months Ended September 30, 2009 | Nine Months Ended September 30, 2008 | Twelve Months Ended December 31, 2008 |
|--|---|---|--|
| Balance at beginning of year | \$ 4,779,662 | \$ 4,185,209 | \$ 4,185,209 |
| Provision for loan losses | 920,000 | 1,721,000 | 3,227,269 |
| Recoveries of loans previously charged-off | 77,096 | 66,800 | 72,298 |
| Loan losses charged-off | (555,723) | (1,288,571) | (2,705,114) |
| Balance at end of year | \$ 5,221,035 | \$ 4,684,438 | \$ 4,779,662 |

Nonperforming assets consist of the following:

| (Dollars in thousands) | September 30, 2009 | December 31, 2008 | September 30, 2008 |
|--|-----------------------------------|----------------------------------|-----------------------------------|
| Nonaccrual loans | \$ 4,332 | \$ 1,208 | \$ 4,457 |
| Restructured loans | | | |
| Total nonperforming loans | \$ 4,332 | \$ 1,208 | \$ 4,457 |
| Other real estate owned | 2,029 | 3,034 | |
| Reposessed automobiles | 68 | 33 | 133 |
| Nonperforming corporate bond investments, at fair value | 634 | | |
| Total nonperforming assets | \$ 7,063 | \$ 4,275 | \$ 4,590 |
| Allowance for loan losses to period end loans | 1.13% | 1.08% | 1.10% |
| Non-performing loans and reposessed assets to period end loans and reposessed assets owned | 1.39% | 0.97% | 1.07% |
| Non-performing assets to period end total assets | 1.29% | 0.81% | 0.92% |

| | September 30, 2009 | December 31, 2008 | September 30, 2008 |
|---|-------------------------------|------------------------------|-------------------------------|
| Impaired loans for which an allowance has been provided | \$ 3,137,846 | \$ 809,221 | \$ 1,863,300 |
| Impaired loans for which no allowance has been provided | 1,832,247 | 81,604 | 3,389,723 |

| | | | | | | |
|--|----|-----------|----|---------|----|-----------|
| | \$ | 4,970,093 | \$ | 890,825 | \$ | 5,253,023 |
| Allowance provided for impaired loans, included in the allowance for loan losses | \$ | 1,425,051 | \$ | 720,395 | \$ | 1,274,158 |

| | | Nine Months Ended September 30, 2009 | | Twelve Months Ended December 31, 2008 | | Nine Months Ended September 30, 2008 |
|--|----|---|----|--|----|---|
| Average balance in impaired loans | \$ | 4,978,382 | \$ | 1,308,909 | \$ | 5,201,012 |
| Interest income recognized on impaired loans | \$ | 171,440 | \$ | 35,940 | \$ | 199,884 |

Total loans past due 90 days or more and still accruing interest were \$448,000 at September 30, 2009, and \$102,000 and \$1,000 on December 31, 2008 and September 30, 2008, respectively. Total loans past due 90 days

Table of Contents

or more and still accruing interest at September 30, 2009, consisted of three separate lending relationships of \$320,000, \$125,000 and \$3,000. These loans were well collateralized and/or were in the process of collection at September 30, 2009.

The Company has adopted Accounting Standard Codification (ASC) 310 Loans and Debt Securities with Deteriorated Credit Quality (previously Financial Accounting Standards Board (FASB) Statement No. 114, Accounting by Creditors for Impairment of a Loan, as amended by FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures). ASC 310, as amended, 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. ASC 310, as amended, also requires certain disclosures about investments in impaired loans and the allowance for loan losses and interest income recognized on loans.

A loan is considered impaired when it is probable that the Bank will be unable to collect all principal and interest amounts according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, expected future cash flows, financial condition of the borrower, and the current economic conditions. A performing loan may be considered impaired if the factors above indicate a need for impairment. A loan on non-accrual status may not be impaired if it is in the process of collection or if the shortfall in payment is insignificant. A delay of less than 30 days or a shortfall of less than 5% of the required principal and interest payments generally is considered insignificant and would not indicate an impairment situation, if in management's judgment the loan will be paid in full. Loans that meet the regulatory definitions of doubtful or loss generally qualify as impaired loans under ASC 310. As is the case for all loans, charge-offs for impaired loans occur when the loan or portion of the loan is determined to be uncollectible.

Note 5. Company-Obligated Mandatorily Redeemable Capital Securities

On September 21, 2006, the Company's wholly-owned Connecticut statutory business trust privately issued \$4 million face amount of the trust's Floating Rate Capital Securities in a pooled capital securities offering (Trust II). Simultaneously, the trust used the proceeds of that sale to purchase \$4.0 million principal amount of the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. The interest rate on the capital security resets every three months at 1.70% above the then current three month LIBOR. Interest is paid quarterly.

Total capital securities at September 30, 2009 and December 31, 2008 were \$4,124,000 for both respective dates. The Trust II issuance of capital securities and the respective subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

Note 6. Earnings Per Share

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

Table of Contents

| | Three Months Ended September 30, 2009 | | Three Months Ended September 30, 2008 | |
|---|--|---------------------------------|--|---------------------------------|
| | Shares | Per Share Amount | Shares | Per Share Amount |
| Basic earnings per share | 3,597,602 | \$ 0.27 | 3,529,347 | \$ 0.26 |
| Effect of dilutive securities, stock-based awards | 12,558 | | 31,184 | |
| | 3,610,160 | \$ 0.26 | 3,560,531 | \$ 0.26 |

| | Nine Months Ended September 30, 2009 | | Nine Months Ended September 30, 2008 | |
|---|---|---------------------------------|---|---------------------------------|
| | Shares | Per Share Amount | Shares | Per Share Amount |
| Basic earnings per share | 3,591,796 | \$ 0.72 | 3,525,633 | \$ 0.82 |
| Effect of dilutive securities, stock-based awards | 9,068 | | 33,384 | |
| | 3,600,864 | \$ 0.72 | 3,559,017 | \$ 0.81 |

Note 7. Stock-Based Compensation

The Company's 2009 Stock Incentive Plan (Plan) provides for the granting of incentive stock options, restricted stock, and phantom stock units to key employees. The Plan replaced the Omnibus Stock Ownership and Long Term Incentive Plan filed with the Securities and Exchange Commission on October 15, 2002, and became effective on May 19, 2009 after shareholders approved the Plan at the annual meeting of shareholders. The Plan makes available 350,000 shares, which may be awarded to directors and employees of the Company in the form of equity-based awards.

Effective January 1, 2006, the Company adopted the provisions of ASC 718 Compensation Stock Compensation (previously SFAS No. 123 (R), Share-Based Payment,) which requires that the Company recognize expense related to the fair value of stock-based compensation awards in net income.

The Company accounts for non-vested shares of restricted stock using the fair market value of the Company's common stock on the date the restricted shares were awarded. The restricted shares issued to executive officers and directors are subject to a vesting period over the next three years. Compensation expense for non-vested shares of restricted stock amounted to \$66,780 and \$68,952, net of any forfeiture, for the three months ended September 30, 2009 and 2008, respectively. Compensation expense for non-vested shares of restricted stock amounted to \$218,843 and \$194,623, net of any forfeiture, for the nine months ended September 30, 2009 and 2008, respectively.

The Company did not grant stock options during the nine months ended September 30, 2009 or September 30, 2008.

Table of Contents

A summary of the status of the options issued under the 2009 Stock Incentive Plan, the Omnibus Stock Ownership and Long-Term Incentive Plan, and the Non-employee Director Stock Option Plan (collectively, the Plans) is presented below:

| | | Nine Months Ended September 30, 2009 | | |
|-----------------------------------|---------------------------------|--|--|------------|
| | Number of Shares | Weighted Average Exercise Price | Average Intrinsic Value (1) | |
| Outstanding at January 1, 2009 | 77,180 | \$ 9.84 | | |
| Granted | | | | |
| Exercised | (10,720) | 9.15 | | |
| Expired | (3,980) | 9.75 | | |
| Outstanding at September 30, 2009 | 62,480 | \$ 9.96 | | |
| Exercisable at end of quarter | 62,480 | \$ 9.96 | | \$ 283,715 |

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 September 30, 2009 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 September 30, 2009. This

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

The total intrinsic value of options exercised during the nine months ended September 30, 2009 and 2008 was \$35,838 and \$132,774, respectively.

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

| | Nine Months Ended September 30, 2009 | |
|---------------------------------|---|---------------------------------------|
| | Number of Shares | Weighted Average Price |
| Nonvested at January 1, 2009 | 38,219 | |
| Granted | 23,500 | \$10.06 |
| Vested | (10,585) | |
| Nonvested at September 30, 2009 | 51,134 | |

As of September 30, 2009, there was \$351,605 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over an approximate period of 29 months.

In addition to the nonvested restricted shares noted above, the Company issued 15,050 non-vested phantom stock units during the nine month period ending September 30, 2009. These units were awarded to members of senior management, and will fully vest on January 1, 2012 if certain Company earnings performance measures are achieved. When fully vested, each stock unit will be exchanged for one share of Fauquier Bankshares, Inc. common stock. For the three and nine month periods ended September 30, 2009, \$24,707 and \$63,586, respectively, of expense was recognized related to the phantom stock units. As of September 30, 2009 approximately \$162,314 of additional compensation cost related to non-vested phantom stock units are expected to be recognized over an approximate period of 27 months.

Table of Contents**Note 8. Employee Benefit Plan**

The following table provides a reconciliation of the changes in the defined benefit pension plan's obligations for the three and nine months ended September 30, 2009 and 2008.

| | Three Months Ended September 30, | |
|------------------------------------|---|-------------|
| | 2009 | 2008 |
| Service cost | \$ 62,707 | \$ 111,081 |
| Interest cost | 73,827 | 77,352 |
| Expected return on plan assets | (65,839) | (149,050) |
| Amortization of transition (asset) | | (4,745) |
| Amortization of prior service cost | | 1,942 |
| Recognized net actuarial loss | | |
| Net periodic benefit cost | \$ 70,695 | \$ 36,580 |

| | Nine Months Ended September 30, | |
|------------------------------------|--|-------------|
| | 2009 | 2008 |
| Service cost | \$ 188,121 | \$ 333,243 |
| Interest cost | 221,481 | 232,056 |
| Expected return on plan assets | (197,517) | (447,150) |
| Amortization of transition (asset) | | (14,235) |
| Amortization of prior service cost | | 5,826 |
| Recognized net actuarial loss | | |
| Net periodic benefit cost | \$ 212,085 | \$ 109,740 |

The Company previously disclosed in its financial statements for the year ended December 31, 2008, that there were no contributions made to its pension plan in 2008. As of September 30, 2009, the pension plan required no additional contributions.

On December 20, 2007, the Company's Board of Directors approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010, the Company will replace the defined benefit pension plan with an enhanced 401(k) plan. On January 18, 2008, the assets within the defined benefit pension plan were redeployed from ownership in various equity and debt mutual fund investments, and into a short-term money market fund in order to preserve asset value until the plan is terminated.

Defined benefit pension plan expenses are projected to be approximately \$285,000 in 2009 and nothing due to curtailment going forward. Expenses for the 401(k) plan are projected to increase from approximately \$154,000 in 2009 to approximately \$625,000 in 2010. Growth in 401(k) after 2010 is projected to increase approximately at the same rate of increase as salaries.

Note 9. Fair Value Measurement

The Company adopted ASC 820 Fair Value Measurement and Disclosures (previously SFAS No. 157, Fair Value Measurements), on January 1, 2008 to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. ASC 820 clarifies that the 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
15

Table of Contents

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).

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2009:

| (In Thousands) Description | Balance at September 30, 2009 | Fair Value Measurements at September 30, 2009 Using Quoted Prices | | |
|-------------------------------|--|--|---|--|
| | | in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | | |
| Available-for-sale securities | \$ 38,275 | \$ 35,644 | \$ 2,631 | \$ |

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:

Loans held for sale: Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the tertiary market. Fair value is based on the price tertiary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. The Company had no loans held for sale as of September 30, 2009.

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

Table of Contents

\

appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Certain assets such as other real estate owned are measured at fair value less the 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 and non-financial assets that were measured at fair value on a nonrecurring basis during the period.

| (In Thousands) | Balance as of September 30, 2009 | Carrying value at September 30, 2009 | | |
|---|---|---|---|--|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets: | | | | |
| Impaired loans, net of reserve for losses | \$ 1,713 | | \$1,270 | \$ 443 |

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

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

Cash and cash equivalents

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

Securities

For securities and marketable equity securities held for investment purposes, fair values are based on quoted market prices or dealer quotes. For other securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair values are based on quoted market prices for similar securities. See Note 2

Securities of the

Table of Contents

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 September 30, 2009 and December 31, 2008, the fair value of loan commitments and standby letters of credit were deemed immaterial.

Table of Contents

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

| (In Thousands) | September 30, 2009 | | December 31, 2008 | |
|---|--------------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |
| Cash and short-term investments | \$ 20,457 | \$ 20,457 | \$ 11,023 | \$ 11,023 |
| Federal funds sold | 10 | 10 | | |
| Securities | 38,275 | 38,275 | 37,839 | 37,839 |
| Loans, net | 455,391 | 511,811 | 434,678 | 452,946 |
| Accrued interest receivable | 1,463 | 1,463 | 1,550 | 1,550 |
| Financial liabilities: | | | | |
| Deposits | \$435,567 | \$437,407 | \$400,294 | \$402,589 |
| FHLB advances | 50,000 | 50,651 | 45,000 | 46,037 |
| Federal funds purchased | 10,000 | 10,000 | 18,275 | 18,275 |
| Company obligated mandatorily redeemable capital securities | 4,124 | 3,062 | 4,124 | 3,116 |
| Accrued interest payable | 651 | 651 | 863 | 863 |

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.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

Table of Contents

For additional discussion of risk factors that may cause our actual future results to differ materially from the results indicated within forward-looking statements, please see Risk Factors in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

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 3,598,537 shares of common stock, par value \$3.13 per share, held by approximately 434 holders of record on September 30, 2009. The Bank has nine full service branch offices located in the Virginia communities of Warrenton, Catlett, The Plains, Sudley Road-Manassas, Old Town-Manassas, New Baltimore, Bealeton and Bristow. The executive offices of the Company and the main office of the Bank are located at 10 Courthouse Square, Warrenton, Virginia 20186. The Bank has leased property in Haymarket, Virginia, where it plans to build its tenth full-service branch offices, scheduled to open during 2010.

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

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

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

The Bank, through its subsidiary Fauquier Bank Services, Inc., has non-controlling 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. 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-

Table of Contents

chartered bank and a member of the Federal Reserve, the Bank is supervised and examined by the Federal Reserve and the Virginia State Corporation Commission. Interest rates on competing investments and general market rates of interest influence deposit flows and costs of funds. Lending activities are affected by the demand for financing of real estate and other types of loans, which in turn is affected by the interest rates at which such financing may be offered and other factors affecting local demand and availability of funds. The Bank faces strong competition in the attraction of deposits (its primary source of lendable funds) and in the origination of loans. Please see **Risk Factors** in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

As of September 30, 2009, the Company had total consolidated assets of \$548.4 million, total loans net of allowance for loan losses of \$455.4 million, total consolidated deposits of \$435.6 million, and total consolidated shareholders equity of \$42.6 million.

CRITICAL ACCOUNTING POLICIES

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

ALLOWANCE FOR LOAN LOSSES. The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on three basic principles of accounting: (i) ASC 450

Contingencies (previously SFAS No. 5, **Accounting for Contingencies**), which requires that losses be accrued when they are probable of occurring and estimable, (ii) ASC 310 **Receivables** (previously SFAS No. 114, **Accounting by Creditors for Impairment of a Loan**), which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance and (iii) Securities and Exchange Commission (**SEC**) Staff Accounting Bulletin No. 102, **Selected Loan Loss Allowance Methodology and Documentation Issues**, which requires adequate documentation to support the allowance for loan losses estimate.

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

Table of Contents**EXECUTIVE OVERVIEW**

This discussion is intended to focus on certain financial information regarding the Company and the Bank and may not contain all the information that is important to the reader. The purpose of this discussion is to provide the reader with a more thorough understanding of our financial statements. As such, this discussion should be read carefully in conjunction with the consolidated financial statements and accompanying notes contained elsewhere in this report. The Bank is the primary independent community bank in its immediate market area as measured by deposit market share. It seeks to be the primary financial service provider for its market area by providing the right mix of consistently high quality customer service, efficient technological support, value-added products, and a strong commitment to the community. The Company and the Bank's primary operating businesses are in commercial and retail lending, deposit accounts and core deposits, and assets under WMS management.

Net income of \$956,000 for the third quarter of 2009, was a 2.2% increase from the net income for the third quarter of 2008 of \$935,000. Net income of \$2.60 million for the nine months ending September 30, 2009, was a 9.8% decrease from the net income for the nine months ending September 30, 2008 of \$2.89 million. Loans, net of reserve, totaling \$455.4 million at September 30, 2009, increased 4.8% when compared with December 31, 2008, and increased 7.6% when compared with September 30, 2008. Deposits, totaling \$435.6 million at September 30, 2009, increased 8.8% compared with December 31, 2008, and increased 7.4% when compared with September 30, 2008. Assets under WMS management, totaling \$303.1 million in market value at September 30, 2009, increased 10.7% from \$273.7 million in market value at September 30, 2008, despite the decline in valuations of the average common stock under management. For example, from September 30, 2008 to September 30, 2009, stocks measured in the S&P 500 index declined by approximately 9.4%.

Net interest income is the largest component of net income, and equals the difference between income generated on interest-earning assets and interest expense incurred on interest-bearing liabilities. Future trends regarding net interest income are dependent on the absolute level of market interest rates, the shape of the yield curve, the amount of lost income from non-performing assets, the amount of prepaying loans, the mix and amount of various deposit types, competition for loans and deposits, and many other factors, as well as the overall volume of interest-earning assets. These factors are individually difficult to predict, and when taken together, the uncertainty of future trends compounds. Based on management's current projections, net interest income may increase through the end of 2009 and beyond as average interest-earning assets increase, but this may be offset in part or in whole by a possible contraction in the Bank's net interest margin resulting from competitive market conditions and/or a flat or inverted yield curve. A steeper yield curve is projected to result in an increase in net interest income, while a flatter or inverted yield curve is projected to result in a decrease in net interest income.

Since the third quarter of 2008, the Bank has seen its competition for deposits increase significantly. The pricing of retail deposits, which traditionally has been at an interest rate less than the interest rate on a FHLB of Atlanta advance of similar term, has exceeded the corresponding FHLB rate by 50 to 100 basis points or more. The increased cost of deposits has resulted in less net interest income and a narrower net interest margin. The intensified competition for deposits is, for the most part, may be the result of liquidity and capitalization pressures faced by many of the large multi-state financial institutions who compete in the Bank's market area.

The Bank's non-performing assets totaled \$7.1 million or 1.29% of total assets at September 30, 2009, as compared with \$4.3 million or 0.81% of total assets at December 31, 2008, and \$4.6 million or 0.92% of total assets at September 30, 2008. Included in total non-performing assets at September 30, 2009 were \$634,000 of non-performing pooled trust preferred corporate bonds. The Bank's non-performing loans and repossessed assets totaled \$6.4 million or 1.39% of total loans and repossessed assets, including real estate owned, at September 30, 2009, as compared with \$4.3 million or 0.97% of total loans and repossessed assets at December 31, 2008, and \$4.6 million or 1.07% of total loans and repossessed assets at September 30, 2008. The provision for loan losses was \$920,000 for the first nine months of 2009 compared with \$1.72 million for the first nine months of 2008. Loan chargeoffs, net of recoveries, totaled \$479,000 or 0.14% of total average loans on an annualized basis for the first nine months of 2009, compared with \$1.22 million or 0.29% of total average loans for the first nine months of 2008. The \$801,000 decrease in the provision for loan losses from the first nine months of 2008 to the first nine months of 2009 was largely in response to the \$743,000 decline in net charge-offs for the respective nine month periods. Total

Table of Contents

allowance for loan losses was \$5.2 million or 1.13% of total loans at September 30, 2009 compared with \$4.8 million or 1.08% of loans at December 31, 2008 and \$4.7 million or 1.10% of loans at September 30, 2008.

Management seeks to continue the expansion of the Bank's branch network. The Bank has leased land in Bristow, Virginia and Haymarket, Virginia, in order to build its ninth and tenth full-service branch offices, respectively. The Bristow office opened on July 13, 2009, and the Haymarket office is scheduled to open in late 2009 or early 2010. 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 from deposits and WMS through the increase of its market share within its marketplace.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2009 AND SEPTEMBER 30, 2008

NET INCOME

Net income was \$956,000 for the third quarter of 2009, a 2.2% increase from the third quarter of 2008 net income of \$935,000. Earnings per share on a fully diluted basis were \$0.26 in 2009 compared with \$0.26 in 2008. Profitability as measured by return on average assets decreased from 0.73% in the third quarter of 2008 to 0.70% for the same period in 2009. Profitability as measured by return on average equity increased from 8.85% to 8.87% over the same respective third quarters in 2008 and 2009. The increase in net income was primarily due to the \$551,000 increase in net interest income in the third quarter of 2009 compared with the third quarter of 2008. This was partially offset by a \$246,000 permanent impairment loss on the Bank's investments in pooled trust preferred securities, as well as increased FDIC insurance expense.

NET INTEREST INCOME AND EXPENSE

Net interest income increased \$551,000 or 11.2% to \$5.47 million for the quarter ended September 30, 2009 from \$4.92 million for the quarter ended September 30, 2008. The increase in net interest income was partially due to the impact of total average earning assets increasing 6.8% from \$470.9 million during the third quarter of 2008 to \$502.7 million during the third quarter of 2009. In addition, the Company's net interest margin increased from 4.15% in the third quarter of 2008 to 4.32% in the third quarter of 2009.

Total interest income decreased \$177,000 or 2.4% to \$7.09 million for the third quarter of 2009 from \$7.27 million for the third quarter of 2008. This decrease was primarily due to the 53 basis point decrease in the yield on average assets from third quarter 2008 to third quarter 2009. This was partially offset by the increase in total average earning assets of \$31.9 million.

The average yield on loans decreased to 5.79% for the third quarter of 2009 compared with 6.23% for the third quarter of 2008. Average loan balances increased \$27.3 million or 6.4% from \$429.4 million during the third quarter of 2008 to \$456.6 million during the third quarter of 2009. The increase in loans outstanding, offset by the decline in rate, resulted in a \$70,000 or 1.0% decrease in interest and fee income from loans for the third quarter of 2009 compared with the same period in 2008.

Average investment security balances decreased \$705,000 from \$38.2 million in the third quarter of 2008 to \$37.5 million in the third quarter of 2009. The tax-equivalent average yield on investments decreased from 5.39% for the third quarter of 2008 to 4.48% for the third quarter of 2009. Together, there was a decrease in interest and dividend income on security investments of \$95,000 or 19.6%, from \$485,000 for the third quarter of 2008 to \$390,000 for the third quarter of 2009. This decrease was primarily due to the decrease in overall market rates as well as the suspension of interest income on two of the Bank's investments in pooled trust preferred corporate bonds. Interest income on deposits in other banks decreased \$9,000 from third quarter 2008 to third quarter 2009.

Total interest expense decreased \$727,000 or 30.9% from \$2.35 million for the third quarter of 2008 to \$1.62 million for the third quarter of 2009 primarily due to the overall decline in shorter-term market interest rates. Interest paid on deposits decreased \$451,000 or 25.6% from \$1.76 million for the third quarter of 2008 to \$1.31 million for the third quarter of 2009. Average NOW deposit balances decreased \$4.6 million from the third quarter of 2008 to the third quarter of 2009, while the average rate on NOW accounts decreased from 0.90% to 0.47% resulting in a reduction of \$93,000 in NOW interest expense for the third quarter of 2009. Average money market account

Table of Contents

balances decreased \$26.5 million from third quarter 2008 to third quarter 2009, while their average rate decreased from 1.95% to 0.57% over the same period resulting in a decrease of \$342,000 of interest expense for the third quarter of 2009. Average time deposit balances increased \$59.9 million from third quarter of 2008 to the third quarter of 2009 while the average rate on time deposits decreased from 3.52% to 2.27% resulting in a decrease of \$46,000 in interest expense for the third quarter of 2009.

Interest expense on federal funds purchased decreased \$8,000 for the third quarter of 2009 when compared to the third quarter of 2008 due to the decline in the average fed funds rate from 2.40% to 1.11%, which offset the \$1.7 million increase in average federal funds purchased. Interest expense on FHLB of Atlanta advances decreased \$245,000 from the third quarter of 2008 to the third quarter of 2009 due to the decrease in the average rate paid on FHLB advances from 3.51% to 2.17%, as well as the decrease in average FHLB advance balances of \$8.4 million. The average rate on total interest-bearing liabilities decreased from 2.36% for the third quarter of 2008 to 1.50% for the third quarter of 2009.

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.

Table of Contents**AVERAGE BALANCES, INCOME AND EXPENSES, AND AVERAGE YIELDS AND RATES
(Dollars in Thousands)**

| | Three Months Ended September 30, 2009 | | | Three Months Ended September 30, 2008 | | |
|---------------------------------------|--|--------------------|-----------------|--|--------------------|-----------------|
| | Average Balances | Income/ Expense | Average Rate | Average Balances | Income/ Expense | Average Rate |
| ASSETS: | | | | | | |
| Loans | | | | | | |
| Taxable | \$ 446,344 | \$ 6,599 | 5.79% | \$ 417,624 | \$ 6,664 | 6.26% |
| Tax-exempt (1) | 8,252 | 150 | 7.09% | 8,642 | 159 | 7.21% |
| Nonaccrual (2) | 2,048 | | | 3,089 | | |
| Total Loans | 456,644 | 6,749 | 5.79% | 429,355 | 6,823 | 6.23% |
| Securities | | | | | | |
| Taxable | 31,955 | 330 | 4.13% | 32,970 | 427 | 5.17% |
| Tax-exempt (1) | 5,575 | 90 | 6.45% | 5,265 | 88 | 6.71% |
| Total securities | 37,530 | 420 | 4.48% | 38,235 | 515 | 5.39% |
| Deposits in banks | 8,506 | 5 | 0.21% | 3,269 | 15 | 1.83% |
| Federal funds sold | 64 | 0.04 | 0.25% | | | |
| Total earning assets | 502,744 | 7,174 | 5.60% | 470,859 | 7,353 | 6.13% |
| Less: Reserve for loan losses | (5,204) | | | (4,491) | | |
| Cash and due from banks | 5,863 | | | 14,658 | | |
| Bank premises and equipment, net | 11,994 | | | 8,451 | | |
| Other assets | 23,613 | | | 17,501 | | |
| Total Assets | \$ 539,010 | | | \$ 506,978 | | |
| LIABILITIES & SHAREHOLDERS | | | | | | |
| EQUITY: | | | | | | |
| Deposits | | | | | | |
| Demand deposits | \$ 63,139 | | | \$ 66,170 | | |
| Interest-bearing deposits | | | | | | |
| NOW accounts | 78,102 | 93 | 0.47% | 82,685 | 186 | 0.90% |
| Money market accounts | 62,894 | 91 | 0.57% | 89,437 | 433 | 1.95% |
| Savings accounts | 42,054 | 69 | 0.65% | 31,748 | 39 | 0.49% |
| Time deposits | 184,797 | 1,057 | 2.27% | 124,902 | 1,104 | 3.52% |

Edgar Filing: FAUQUIER BANKSHARES, INC. - Form 10-Q

| | | | | | | |
|---|------------|----------|-------|------------|----------|-------|
| Total interest-bearing deposits | 367,847 | 1,310 | 1.41% | 328,772 | 1,762 | 2.13% |
| Federal funds purchased | 5,624 | 16 | 1.11% | 3,953 | 24 | 2.40% |
| Federal Home Loan Bank advances | 49,511 | 275 | 2.17% | 57,880 | 519 | 3.51% |
| Capital securities of subsidiary trust | 4,124 | 23 | 2.23% | 4,124 | 46 | 4.34% |
| Total interest-bearing liabilities | 427,106 | 1,624 | 1.50% | 394,729 | 2,351 | 2.36% |
| Other liabilities | 6,027 | | | 4,041 | | |
| Shareholders' equity | 42,738 | | | 42,038 | | |
| Total Liabilities & Shareholders' Equity | \$ 539,010 | | | \$ 506,978 | | |
| Net interest spread | | \$ 5,550 | 4.09% | | \$ 5,002 | 3.77% |
| Interest expense as a percent of average earning assets | | | 1.28% | | | 1.98% |
| Net interest margin | | | 4.32% | | | 4.15% |

(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.

Table of Contents**RATE/VOLUME ANALYSIS**

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

RATE / VOLUME VARIANCE**(In Thousands)**

Three Months Ended September 30, 2009 Compared to
Three Months Ended September 30, 2008

| | Change | Due to Volume | Due to Rate |
|--|---------------|--------------------------|------------------------|
| INTEREST INCOME | | | |
| Loans; taxable | \$ (64) | \$ 458 | (522) |
| Loans; tax-exempt (1) | (10) | (7) | (3) |
| Securities; taxable | (96) | (13) | (83) |
| Securities; tax-exempt (1) | 2 | 5 | (3) |
| Deposits in banks | (11) | 25 | (36) |
| Federal funds sold | | | |
| Total Interest Income | (179) | 468 | (647) |
| INTEREST EXPENSE | | | |
| NOW accounts | (93) | (10) | (83) |
| Money market accounts | (342) | (128) | (214) |
| Savings accounts | 30 | 13 | 17 |
| Time deposits | (46) | 529 | (575) |
| Federal funds purchased and securities sold under agreements to repurchase | (8) | 10 | (18) |
| Federal Home Loan Bank advances | (245) | (75) | (170) |
| Capital securities of subsidiary trust | (23) | | (23) |
| Total Interest Expense | (727) | 339 | (1,066) |
| Net Interest Income | \$ 548 | \$ 129 | \$ 419 |

(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 \$360,000 for the third quarter of 2009, compared with \$431,000 for the third quarter of 2008. The amount of the provision for loan loss was based upon management's continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank's delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. Greater weight is given to the loss history by loan category, prolonged changes in portfolio delinquency trends by loan category, and changes in economic trends. There can be no assurances, however, that future losses will not exceed estimated amounts, or that increased amounts of provisions for loan losses will not be required in future periods.

The \$71,000 decrease in the provision for loan losses during the third quarter of 2009, compared to the same quarter one year earlier, was largely in response to the decline in net loan charge-offs during the quarter ended September 30, 2009 compared to the previous year.

OTHER INCOME

Total other income increased by \$9,000 from \$1.18 million for the third quarter of 2008 to \$1.19 million in the third quarter of 2009. Non-interest income is derived primarily from non-interest fee income, which consists primarily of fiduciary and other Wealth Management fees, service charges on deposit accounts, and other fee income. The decrease in other income primarily reflects declines in Wealth Management income and service charges on deposit accounts. Additionally, during the third quarters of 2009 and 2008, the Bank recognized impairment losses in its

Table of Contents

investment portfolio. During the third quarter of 2009, the Bank recognized a \$246,000 loss on the permanent impairment on its investment in pooled trust preferred securities. During the third quarter of 2008, the Bank recognized a \$298,000 loss on the permanent impairment on its investment in Freddie Mac preferred stock.

Wealth Management income decreased \$7,000 or 2.2% from the third quarter of 2008 to the third quarter of 2009, as assets under management declined from year to year, primarily due to the decline in overall stock market valuations. Further growth or decline in Wealth Management fees is significantly dependent on the growth or decline in value of the U.S. and international stock and bond markets.

Service charges on deposit accounts decreased \$22,000 or 3.0% to \$701,000 for the three months ending September 30, 2009 compared to one year earlier. Due to changes in economic conditions and consumer confidence, it appears that customer's usage of various deposit services has lessened. Whether this is a temporary cyclical change, or a more permanent structural change is difficult to determine at this point in time.

Other service charges, commissions and fees decreased \$18,000 or 4.0% from \$437,000 in third quarter 2008 to \$419,000 in third quarter 2009. Included in other service charges, commissions, and income is Bank Owned Life Insurance (BOLI) income, which was \$103,000 during the third quarter of 2009 compared with \$104,000 for the same quarter one year earlier. Total BOLI was \$10.7 million at September 30, 2009, compared with \$10.3 million one year earlier.

OTHER EXPENSE

Total other expense increased \$765,000 or 18.0% during the third quarter of 2009 compared with the third quarter of 2008, primarily due to increased compensation expense and FDIC insurance assessment from third quarter 2008 to third quarter 2009.

Salaries and employees' benefits increased \$536,000 or 25.0%, primarily due to the year-to-year changes in the accrual of incentive compensation, as well as increase in the total number of staff and pension expense associated with the defined benefit pension plan scheduled to be terminated at December 31, 2009. During the third quarter of 2008, the Bank did not accrue any incentive compensation based upon not meeting established levels of pre-tax, pre-incentive income at that time. By comparison, the Bank accrued approximately \$180,000 for incentive compensation during the third quarter of 2009 by meeting established levels of pre-tax, pre-incentive income. Such 2009 incentives will be paid, or reversed based upon audited total year results in early 2010. Active full-time equivalent personnel totaled 153 at September 30, 2009 compared with 144 at September 30, 2008. The September 2009 data includes seven full-time equivalent positions used to staff the Bristow branch office which opened in July 2009.

On December 20, 2007, the Company's Board of Directors (Board) approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010 the Board approved to replace the defined benefit pension plan with an enhanced 401(k) plan. Defined benefit pension plan expenses are projected to be approximately \$285,000 in 2009, and nothing due to curtailment going forward. Expenses for the 401(k) plan are projected to increase from approximately \$154,000 in 2009 to approximately \$625,000 in 2010. Growth in 401(k) after 2010 is projected to increase approximately at the same rate of increase as salaries.

The Bank expects personnel costs, consisting primarily of salary and benefits, to continue to be its largest other expense. As such, the most important factor with regard to potential changes in other expenses is the expansion of staff. The cost of any additional staff expansion, however, would be expected to be offset by the increased revenue generated by the additional services that the new staff would enable the Bank to perform. For the remainder of 2009, the Company projects six additional full-time equivalent positions excluding the impact of the Haymarket office. In late 2009 or early 2010, the Company will also increase full-time equivalent personnel in order to staff the branch office in Haymarket.

Net occupancy expense increased \$59,000 or 18.0%, primarily due to expenses associated with the July 2009 opening of the Bristow branch. Furniture and equipment expense decreased \$55,000 or 17.5%, from third quarter 2008 to third quarter 2009 due to decreases in the depreciation of technology equipment and software.

Table of Contents

Marketing expense increased \$41,000 or 28.9% from \$143,000 for the third quarter of 2008 to \$184,000 for the third quarter of 2009. This increase primarily reflects the marketing campaigns associated with the new Bristow branch opening in July 2009. Marketing expenses for all of 2009 are projected to be approximately the same as 2008.

Legal, auditing and consulting expense decreased \$41,000 or 15.8% in the third quarter of 2009 compared with the third quarter of 2008.

Data processing expense decreased \$93,000 or 28.5% for the third quarter of 2009 compared with the same time period in 2008. The Bank outsources much of its data processing to a third-party vendor, and during the third quarter of 2009 changed vendors, which generated a non-recurring reduction of expense. Going forward for the remainder of 2009 and 2010, data processing expenses are projected to approximate third quarter 2008 rather than third 2009.

FDIC deposit insurance assessments increased from \$64,000 for the third quarter of 2008 to \$145,000 for the third quarter of 2009. FDIC expense is projected to increase from \$291,000 for all of 2008 to approximately \$820,000 for 2009, taking into consideration the \$240,000 special assessment expense required by the FDIC at June 30, 2009.

Other operating expenses increased \$237,000 or 34.9% in the third quarter of 2009 compared with the third quarter of 2008. The increase in expense primarily reflects an increase in non-loan charge-offs from \$89,000 for the third quarter of 2008 to \$212,000 for the third quarter of 2009. Included in non-loan charge-offs are losses related to robbery and ATM fraud.

INCOME TAXES

Income tax expense was \$323,000 for the quarter ended September 30, 2009 compared with \$479,000 for the quarter ended September 30, 2008. The effective tax rates were 25.3% and 33.9% for the third quarter of 2009 and 2008, respectively. The effective tax rate differs from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, and income from the BOLI purchases. The effective tax rate for the third quarter of 2008 was impacted by the realization of the impairment loss on the Freddie Mac preferred stock, but the delay of the tax benefit from the loss until the fourth quarter of 2008 due to the timing of changes in federal tax legislation.

COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009 AND SEPTEMBER 30, 2008**NET INCOME**

Net income was \$2.60 million for the first nine months of 2009, a 9.8% decrease from the first nine months of 2008 net income of \$2.89 million. Earnings per share on a fully diluted basis were \$0.72 in 2009 compared to \$0.81 in 2008. Profitability as measured by return on average assets decreased from 0.77% in the first nine months of 2008 to 0.66% for the same period in 2009. Profitability as measured by return on average equity decreased from 9.04% to 8.26% over the same respective nine month periods in 2008 and 2009. The decline in net income and the corresponding profitability measures was primarily due to the loss on impairment of the Company's investment in pooled trust preferred corporate bonds and Silverton Bank common stock totaling \$412,000, the decline in wealth management and deposit fee income, the loss on the sale of other real estate owned totaling \$136,000, the expenses associated with the contested election of directors at the 2009 annual meeting of shareholders totaling approximately \$291,000, and the increase in FDIC insurance of \$588,000. These were partially offset by a \$982,000 increase in net interest income in the first nine months of 2009 compared with the first nine months of 2008, and a decrease of \$801,000 in the provision for loan losses.

The following table reconciles various non-GAAP adjustments to net income on a GAAP basis.

| | (Dollars in Thousands) | | | |
|---|------------------------|----------------|----------------|----------------------------|
| | Before Taxes | Tax Expense | After Taxes | Per Fully-Diluted Share |
| For the Nine Months Ended September 30, 2009 | | | | |
| Net income on GAAP basis | \$3,539 | \$ 937 | \$2,603 | \$ 0.723 |

| | | | | |
|-----------------------------|-----|----|-----|-------|
| Plus: Proxy contest expense | 291 | 99 | 192 | 0.053 |
| | 28 | | | |

Table of Contents

| | (Dollars in Thousands) | | | Per Fully-Diluted |
|--|------------------------|---------|---------|-------------------|
| | Before | Tax | After | Share |
| | Taxes | Expense | Taxes | |
| Plus: FDIC special assessment expense | 240 | 82 | 158 | 0.044 |
| Net income after non-GAAP adjustment items | \$4,070 | \$1,118 | \$2,953 | \$ 0.820 |

Tax expense is computed using a federal tax rate of 34%.

For Nine Months
ended
September 30, 2009

Return on Average Assets:

| | |
|--|-------|
| Net income on GAAP basis | 0.66% |
| Net income after non-GAAP adjustment items | 0.75% |

Return on Average Equity:

| | |
|--|-------|
| Net income on GAAP basis | 8.26% |
| Net income after non-GAAP adjustment items | 9.37% |

NET INTEREST INCOME AND EXPENSE

Net interest income increased \$982,000 or 6.7% to \$15.59 million for the nine months ended September 30, 2009 from \$14.61 million for the nine months ended September 30, 2008. The increase in net interest income was due to the impact of total average earning assets increasing 6.7% from \$462.2 million during the first nine months of 2008 to \$493.0 million during the first nine months of 2009. In addition, there was an increase in the Company's net interest margin from 4.21% in the first nine months of 2008 to 4.22% in the first nine months of 2009.

Total interest income decreased \$939,000 or 4.3% to \$20.80 million for the first nine months of 2009 from \$21.74 million for the first nine months of 2008. This decrease was primarily due to the 64 basis point decrease in the yield on average assets from the first nine months 2008 to the first nine months 2009. This was partially offset by the increase in total average earning assets of \$30.8 million.

The average yield on loans decreased to 5.78% for the first nine months of 2009 compared with 6.40% for the first nine months of 2008. Average loan balances increased \$28.9 million or 6.9% from \$420.8 million during the first nine months of 2008 to \$449.8 million during the first nine months of 2009. The decline in rate, partially offset by the increase in loans outstanding, resulted in a \$705,000 or 3.5% decrease in interest and fee income from loans for the first nine months of 2009 compared with the same period in 2008.

Average investment security balances decreased \$1.5 million from \$38.1 million in the first nine months of 2008 to \$36.6 million in the first nine months of 2009. The tax-equivalent average yield on investments decreased from 5.17% for the first nine months of 2008 to 4.71% for the first nine months of 2009. Together, there was a decrease in interest and dividend income on security investments of \$185,000 or 13.3%, from \$1.39 million for the first nine months of 2008 to \$1.20 million for the first nine months of 2009. This decrease was primarily due to the suspension of dividend income on FHLB of Atlanta stock during the first six months of 2009, as well as the decline in average balances on securities. Interest income on deposits in other banks decreased \$16,000 from the first nine months of 2008 to the first nine months of 2009. Interest income on federal funds sold decreased \$33,000 from the first nine months of 2008 to the first nine months of 2009, reflecting a decline in the average balances from \$1.6 million to \$102,000.

Total interest expense decreased \$1.92 million or 26.9% from \$7.13 million for the first nine months of 2008 to \$5.21 million for the first nine months of 2009 primarily due to the overall decline in shorter-term market interest rates. Interest paid on deposits decreased \$1.18 million or 21.4% from \$5.49 million for the first nine months of 2008 to \$4.31 million for the first nine months of 2009. Average NOW deposit balances decreased \$8.7 million from the

first nine months of 2008 to the first nine months of 2009, while the average rate on NOW accounts decreased from 1.02% to 0.43% resulting in a reduction of \$403,000 in NOW interest expense for the first nine months of 2009. Average money market account balances decreased \$26.0 million from the first nine months 2008 to the first nine months 2009, while their average rate decreased from 2.15% to 0.79% over the same period resulting in a

Table of Contents

decrease of \$1.12 million of interest expense for the first nine months of 2009. Average time deposit balances increased \$57.6 million from the first nine months of 2008 to the first nine months of 2009 while the average rate on time deposits decreased from 3.76% to 2.76% resulting in an increase of \$338,000 in interest expense for the first nine months of 2009.

Interest expense on federal funds purchased decreased \$49,000 for the first nine months of 2009 when compared to the first nine months of 2008 due to the decline in the average fed funds rate from 2.93% to 1.22%, partially offset by the \$223,000 increase in average federal funds purchased. Interest expense on FHLB of Atlanta advances decreased \$630,000 from the first nine months of 2008 to the first nine months of 2009 due to the decrease in the average rate paid on FHLB advances from 3.61% to 1.85%, partially offset by the increase in average FHLB advance balances of \$3.8 million. The expense on the distribution on capital securities of subsidiary trusts decreased \$67,000 for the first nine months of 2009 when compared to the first nine months of 2008 due to the decline in their three-month LIBOR-indexed interest rate from 4.95% to 2.84%.

The average rate on total interest-bearing liabilities decreased from 2.47% for the first nine months of 2008 to 1.67% for the first nine months of 2009.

Table of Contents

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)

| | Nine Months Ended September 30, 2009 | | | Nine Months Ended September 30, 2008 | | |
|---|---|--------------------|-----------------|---|--------------------|-----------------|
| | Average Balances | Income/ Expense | Average Rate | Average Balances | Income/ Expense | Average Rate |
| ASSETS: | | | | | | |
| Loans | | | | | | |
| Taxable | \$ 439,632 | \$ 19,254 | 5.78% | \$ 410,676 | \$ 20,007 | 6.38% |
| Tax-exempt (1) | 8,411 | 441 | 6.91% | 7,916 | 433 | 7.18% |
| Nonaccrual (2) | 1,719 | | | 2,244 | | |
| Total Loans | 449,762 | 19,695 | 5.78% | 420,836 | 20,440 | 6.40% |
| Securities | | | | | | |
| Taxable | 31,061 | 1,023 | 4.39% | 32,675 | 1,211 | 4.71% |
| Tax-exempt (1) | 5,537 | 271 | 6.52% | 5,386 | 265 | 6.55% |
| Total securities | 36,598 | 1,294 | 4.71% | 38,061 | 1,476 | 5.17% |
| Deposits in banks | 6,535 | 11 | 0.23% | 1,693 | 28 | 2.16% |
| Federal funds sold | 102 | 0.2 | 0.25% | 1,640 | 33 | 2.71% |
| Total earning assets | 492,997 | 21,000 | 5.63% | 462,230 | 21,977 | 6.27% |
| Less: Reserve for loan losses | (5,034) | | | (4,285) | | |
| Cash and due from banks | 8,041 | | | 15,550 | | |
| Bank premises and equipment, net | 10,154 | | | 8,160 | | |
| Other assets | 21,438 | | | 16,825 | | |
| Total Assets | \$ 527,596 | | | \$ 498,480 | | |
| LIABILITIES & SHAREHOLDERS EQUITY: | | | | | | |
| Deposits | | | | | | |
| Demand deposits | \$ 63,623 | | | \$ 67,617 | | |

Edgar Filing: FAUQUIER BANKSHARES, INC. - Form 10-Q

| | | | | | | |
|---|----------------|-----------|-----------|----------------|-----------|-----------|
| Interest-bearing deposits | | | | | | |
| NOW accounts | 77,359 | 252 | 0.43% | 86,067 | 655 | 1.02% |
| Money market accounts | 68,145 | 401 | 0.79% | 94,142 | 1,517 | 2.15% |
| Savings accounts | 36,052 | 117 | 0.43% | 31,363 | 111 | 0.47% |
| Time deposits | 171,397 | 3,540 | 2.76% | 113,762 | 3,202 | 3.76% |
| Total interest-bearing deposits | 352,953 | 4,310 | 1.63% | 325,334 | 5,485 | 2.25% |
| Federal funds purchased | 4,207 | 39 | 1.22% | 3,984 | 87 | 2.93% |
| Federal Home Loan Bank advances | 54,795 | 771 | 1.85% | 50,961 | 1,401 | 3.61% |
| Capital securities of subsidiary trust | 4,124 | 89 | 2.84% | 4,124 | 156 | 4.95% |
| Total interest-bearing liabilities | 416,079 | 5,209 | 1.67% | 384,403 | 7,129 | 2.47% |
| Other liabilities | 5,764 | | | 3,829 | | |
| Shareholders' equity | 42,130 | | | 42,631 | | |
| Total Liabilities & Shareholders' Equity | \$ 527,596 | | | \$ 498,480 | | |
| Net interest spread | | \$ 15,791 | 3.96% | | \$ 14,848 | 3.80% |
| Interest expense as a percent of average earning assets | | | 1.41% | | | 2.05% |
| Net interest margin | | | 4.22% | | | 4.21% |

(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.

Table of Contents**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)**

Nine Months Ended September 30, 2009 Compared to
Nine Months Ended September 30, 2008

| | Change | Due to Volume | Due to Rate |
|--|----------------|--------------------------|------------------------|
| INTEREST INCOME | | | |
| Loans; taxable | \$ (754) | \$ 1,411 | (2,165) |
| Loans; tax-exempt (1) | 8 | 27 | (19) |
| Securities; taxable | (188) | (60) | (128) |
| Securities; tax-exempt (1) | 6 | 7 | (1) |
| Deposits in banks | (17) | 80 | (97) |
| Federal funds sold | (33) | (31) | (2) |
| Total Interest Income | (978) | 1,434 | (2,412) |
| INTEREST EXPENSE | | | |
| NOW accounts | (403) | (66) | (337) |
| Money market accounts | (1,116) | (419) | (697) |
| Savings accounts | 6 | 17 | (11) |
| Time deposits | 338 | 1,622 | (1,284) |
| Federal funds purchased and securities sold under agreements to repurchase | (48) | 5 | (53) |
| Federal Home Loan Bank advances | (631) | 105 | (736) |
| Capital securities of subsidiary trust | (67) | | (67) |
| Total Interest Expense | (1,921) | 1,264 | (3,185) |
| Net Interest Income | \$ 943 | \$ 170 | \$ 773 |

(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 \$920,000 for the first nine months of 2009, compared with \$1.72 million for the first nine months of 2008.

The \$801,000 decrease in the provision for loan losses during the first nine months of 2009, compared to the same period one year earlier, was largely in response to the decline in loan charge-offs during the nine months ended September 30, 2009.

OTHER INCOME

Total other income decreased by \$761,000 from \$4.28 million for the first nine months of 2008 to \$3.51 million in the first nine months of 2009. The decrease in other income primarily reflects the loss on the impairment of securities totaling \$412,000, and the loss on sale of other real estate owned properties of \$136,000 compared to a gain of \$26,000 in 2008, as well as declines in Wealth Management income and service charges on deposit accounts. In addition, there was the recognition of a \$217,000 gain due to the Bank's ownership interest in Infinex, and an \$88,000 gain on sale of investments during the first nine months of 2008 that did not reoccur in 2009.

Wealth Management income decreased \$185,000 or 18.5% from the first nine months of 2008 to the first nine months of 2009, as assets under management declined from year to year, primarily due to the decline in overall stock market valuations.

Table of Contents

Service charges on deposit accounts decreased \$72,000 or 3.4% to \$2.03 million for the first nine months of 2009 compared to the same period one year earlier.

Other service charges, commissions and fees decreased \$266,000 or 18.0% from \$1.48 million in the first nine months 2008 to \$1.21 million in the first nine months 2009. This decrease was primarily due to the recognition of a \$217,000 gain due to the Bank's ownership interest in Infinex during 2008. Also included in other service charges, commissions, and income is BOLI income, which was \$304,000 during the first nine months of 2009 compared with \$310,000 for the same period one year earlier.

OTHER EXPENSE

Total other expense increased \$1.59 million or 12.2% during the first nine months of 2009 compared with the first nine months of 2008. The reasons for the increase are primarily due to the \$588,000 increase in FDIC deposit insurance assessment, the expenses related to the proxy contest totaling \$291,000, and a \$215,000 increase in pension expense.

Salaries and employees' benefits increased \$594,000 or 8.8%, primarily due to an increase in staff, including the staffing of the Bristow branch office opened in July 2009, and pension expense associated with the termination of the defined benefit pension plan at December 31, 2009.

Net occupancy expense increased \$54,000 or 5.7%, primarily due to the Bristow branch office opening in July 2009, and furniture and equipment expense decreased \$77,000 or 8.7% from the first nine months 2008 to the first nine months 2009 due to reduced depreciation of technology hardware and software.

Marketing expense increased \$24,000 or 5.1% from \$468,000 for the first nine months of 2008 to \$492,000 for the first nine months of 2009. This increase primarily reflects timing differences of direct mail campaigns targeting both individual households and small businesses, as well as with marketing expenses associated with the opening of the Bristow branch.

Consulting expense, which includes legal and accounting professional fees, increased \$230,000 or 28.7% in the first nine months of 2009 compared with the first nine months of 2008. This increase primarily 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 \$81,000 or 8.2% for the first nine months of 2009 compared with the same time period in 2008 for the same reasons discussed in the three month comparison.

The FDIC deposit insurance assessment increased from \$87,000 for the first nine months of 2008 to \$675,000 for the first nine months of 2009, including approximately \$240,000 for the FDIC's special assessment.

Other operating expenses increased \$259,000 or 12.4% in the first nine months of 2009 compared with the first nine months of 2008. The increase in expense primarily reflects an increase in other 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 was \$937,000 for the nine months ended September 30, 2009 compared with \$1.22 million for the nine months ended September 30, 2008. The effective tax rates were 26.5% and 29.8% for the first nine months of 2009 and 2008, respectively.

COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2009 AND DECEMBER 31, 2008

Total assets were \$548.4 million at September 30, 2009 compared with \$514.5 million at December 31, 2008, an increase of 6.6% or \$33.9 million. Balance sheet categories reflecting significant changes included interest-bearing deposits in other banks, total loans, other real estate owned, deposits, federal funds purchased, FHLB advances, and company-obligated mandatorily redeemable capital securities. Each of these categories is discussed below.

Table of Contents

INTEREST-BEARING DEPOSITS IN OTHER BANKS. Interest-bearing deposits in other banks were \$15.0 million at September 30, 2009, reflecting an increase of \$11.6 million from December 31, 2008. The increase in interest-bearing deposits in other banks was primarily due to the increase in cash held at the Federal Reserve. The higher balance at September 30, 2009 was in order to satisfy reserve requirements and temporary placement of liquidity.

LOANS. Total net loan balance after allowance for loan losses was \$455.4 million at September 30, 2009, which represents an increase of \$20.7 million or 4.8% from \$434.7 million at December 31, 2008. 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.

BANK PREMISES AND EQUIPMENT, NET. Bank premises and equipment increased \$4.2 million from December 31, 2008 to September 30, 2009 due to the capitalization of construction costs associated with the building of new Bristow, Haymarket and View Tree, Warrenton branch offices.

OTHER REAL ESTATE OWNED. Other real estate owned declined by \$1.0 million from December 31, 2008 to September 30, 2009 due to the sale of one property at a loss of \$136,000 during the first quarter of 2009. The loss was reflected in the consolidated statement of income for the nine months ended September 30, 2009.

DEPOSITS. For the nine months ended September 30, 2009, total deposits increased by \$35.3 million or 8.8% when compared with total deposits at December 31, 2008. Non-interest-bearing deposits decreased by \$4.7 million and interest-bearing deposits increased by \$40.0 million. Included in interest-bearing deposits at September 30, 2009 and December 31, 2008 were \$50.1 million and \$37.4 million, respectively of brokered deposits as defined by the Federal Reserve. Of the \$50.1 million in brokered deposits, \$30.9 million represent deposits of Bank customers, exchanged through the CDAR s network. With the CDAR s program, funds are placed into certificate of deposits issued by other banks in the network, in increments of less than \$250,000, to ensure both principal and interest are eligible for complete FDIC coverage. These deposits are exchanged with other member banks on a dollar-for-dollar basis, bringing the full amount of our customers deposits back to the Bank and making these funds fully available for lending in our community. The decline in the Bank s non-interest-bearing deposits and the increase in interest-bearing deposits during the first nine months of 2009 were the result of many factors difficult to segregate and quantify, and equally difficult to use as factors for future projections. The economy, local competition, retail customer preferences, changes in seasonal cash flows by both commercial and retail customers, changes in business cash management practices by Bank customers, the relative pricing from wholesale funding sources, and the Bank s funding needs all contributed to the change in deposit balances. The Bank projects to increase its transaction accounts and other deposits 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.

FEDERAL FUNDS PURCHASED and FEDERAL HOME LOAN BANK ADVANCES. Federal funds purchased decreased by \$8.3 million from December 31, 2008 to September 30, 2009, but were largely replaced by the \$5.0 million increase in FHLB of Atlanta advances.

COMPANY-OBLIGATED MANDATORILY REDEEMABLE CAPITAL SECURITIES OF SUBSIDIARY TRUST (capital securities). On September 21, 2006, 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. The Company used the offering proceeds for the purposes of expansion and the repurchase of additional shares of its common stock. 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.

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. Both the capital securities and the subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

Table of Contents**ASSET QUALITY**

Non-performing assets, in most cases, consist of loans and corporate bonds that are 90 days or more past due and for which the accrual of interest has been discontinued. Management evaluates all assets 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 and corporate bonds are placed on non-accrual status when they have been specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loans are well secured and in the process of collection. Any unpaid interest previously accrued is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other non-accrual loans is recognized only to the extent of interest payments received.

Non-performing assets totaled \$7.1 million or 1.29% of total assets at September 30, 2009, compared with \$4.3 million or 0.81% of total assets at December 31, 2008, and \$4.6 million or 0.92% of total assets at September 30, 2008. Included within non-performing assets at September 30, 2009 are two pooled trust-preferred corporate bonds totaling \$634,326. Further discussion about these two bonds can be found in Note 2. Securities.

Non-performing loans and repossessed assets totaled \$6.4 million or 1.39% of total loans and repossessed assets at September 30, 2009, compared with \$4.3 million or 0.97% of total loans and repossessed assets at December 31, 2008, and \$4.6 million or 1.07% of total loans and repossessed assets at September 30, 2008.

Total loans past due 90 days or more and still accruing interest were \$448,000 at September 30, 2009, and \$102,000 and \$1,000 on December 31, 2008 and September 30, 2008, respectively. 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 September 30, 2009, there are no other interest-bearing assets that would be subject to disclosure as either non-performing or impaired.

At September 30, 2009, no concentration of loans to commercial borrowers engaged in similar activities exceeded 10% of total loans. The largest industry concentration at September 30, 2009 was approximately 5.1% of loans to the hospitality industry (hotels, motels, inns, etc.). For more information regarding the Bank's concentration of loans collateralized by real estate, please refer to the discussion under Risk Factors in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2008 entitled We have a high concentration of loans secured by real estate and a 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 September 30, 2009, construction and land loans were \$39.1 million or 68.7% of the concentration limit. Commercial real estate loans, including construction and land loans, were \$125.6 million or 220.6% of the concentration level.

The allowance for loan losses as a percentage of total loans increased from 1.08% at December 31, 2008 to 1.13% at September 30, 2009 reflecting the increase in non-accrual loans and changes in the local economy, particularly the increase in the unemployment rate in Fauquier County, which increased from an average of 3.5% for 2008 to 5.5% for the second quarter of 2009.

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.

Table of Contents**CONTRACTUAL OBLIGATIONS**

During March 2008, the Bank sold its Route 29 Warrenton branch building and land as part of an exchange of real estate properties. The property the Bank received, also on Route 29 in Warrenton, Virginia, will be the future site of a larger, more conveniently located branch building. During the time-period of construction of the new branch site, the Bank will rent the existing Route 29 Warrenton branch building for approximately \$180,000 on an annualized basis. During June 2009, the Company and Bank changed its third-party vendor providing core data processing services. There is no material change projected for data processing expense as result of this change in vendors for the remainder 2009.

As of September 30, 2009, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in Management's Discussion and Analysis in the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

OFF-BALANCE SHEET ARRANGEMENTS

As of September 30, 2009, there have been no material changes to the off-balance sheet arrangements disclosed in Management's Discussion and Analysis of Financial Condition and results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

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 I Capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier I Capital to average assets (as defined in the regulations). Management believes, as of September 30, 2009, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

At September 30, 2009 and December 31, 2008, the Company exceeded its regulatory capital ratios, as set forth in the following table:

RISK BASED CAPITAL RATIOS
(Dollars in Thousands)

| | September 30, 2009 | December 31, 2008 |
|---|--------------------------|-------------------------|
| Tier 1 Capital: | | |
| Shareholders' Equity | \$ 42,601 | \$ 41,488 |
| Plus: Unrealized loss on securities available for sale/FAS 158, net | 1,865 | 2,217 |
| Less: Unrealized loss on equity securities, net | | (13) |
| Plus: Company-obligated mandatorily redeemable capital securities | 4,000 | 4,000 |
| Total Tier 1 Capital | 48,466 | 47,692 |
| Tier 2 Capital: | | |
| Allowable Allowance for Loan Losses | 5,221 | 4,780 |
| Total Capital: | 53,687 | 52,472 |

| | | | | |
|---------------------------------------|----|---------|----|---------|
| Risk Weighted Assets: | \$ | 448,587 | \$ | 416,265 |
| Regulatory Capital Ratios: | | | | |
| Leverage Ratio | | 9.00% | | 9.37% |
| Tier 1 to Risk Weighted Assets | | 10.80% | | 11.38% |
| Total Capital to Risk Weighted Assets | | 11.97% | | 12.52% |

Table of Contents**CAPITAL RESOURCES AND LIQUIDITY**

Shareholders' equity totaled \$42.6 million at September 30, 2009 compared with \$41.5 million at December 31, 2008 and \$40.6 million at September 30, 2008. 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 no shares and 7,332 shares of stock during the first nine months of 2009 and 2008, respectively.

Accumulated other comprehensive income/loss decreased to an unrealized loss net of tax benefit of \$1.8 million at September 30, 2009 compared with \$2.2 million at December 31, 2008. The decline in the accumulated other comprehensive loss was attributable to the increase in the unrealized loss on investment securities held available for sale, primarily the unrealized loss on the Bank's investment in pooled trust preferred securities.

As discussed above under "Company-obligated Mandatorily Redeemable Capital Securities of Subsidiary Trust", in 2006, the Company established a subsidiary trust that issued \$4.0 million of capital securities as part of a separate pooled trust preferred security offering with other financial institutions. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve's capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital. As discussed above under "Capital", banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios. As of September 30, 2009, the appropriate regulatory authorities have categorized the Company and the Bank as well capitalized.

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

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled \$20.4 million at September 30, 2009 compared with \$11.0 million at December 31, 2008. 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 \$12.6 million was unpledged and readily salable at September 30, 2009.

Furthermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately \$94.0 million at September 30, 2009 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with the Federal Reserve and various other commercial banks totaling approximately \$74.8 million. At September 30, 2009, \$50.0 million of the FHLB of Atlanta line of credit and \$10.0 million of federal funds purchased lines of credit were in use.

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 operation 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.

Table of Contents

The following table sets forth information relating to the Company's sources of liquidity and the outstanding commitments for use of liquidity at September 30, 2009 and December 31, 2008. The liquidity coverage ratio is derived by dividing the total sources of liquidity by the outstanding commitments for use of liquidity.

LIQUIDITY SOURCES AND USES
(Dollars in Thousands)

| | September 30, 2009 | | | December 31, 2008 | | |
|--|--------------------|-----------|------------|-------------------|-----------|------------|
| | Total | In Use | Available | Total | In Use | Available |
| Sources: | | | | | | |
| Federal funds borrowing lines of credit | \$ 74,840 | \$ 10,000 | \$ 64,840 | \$ 88,195 | \$ 18,275 | \$ 69,920 |
| Federal Home Loan Bank advances | 94,027 | 50,000 | 44,027 | 115,214 | 45,000 | 70,214 |
| Federal funds sold | | | 10 | | | |
| Securities, available for sale and unpledged at fair value | | | 12,638 | | | 8,428 |
| Total short-term funding sources | | | \$ 111,515 | | | \$ 148,562 |
| Uses: | | | | | | |
| Unfunded loan commitments and lending lines of credit | | | \$ 81,850 | | | \$ 74,023 |
| Letters of credit | | | 9,281 | | | 5,366 |
| Total potential short-term funding uses | | | \$ 91,131 | | | \$ 79,389 |
| Ratio of short-term funding sources to potential short-term funding uses | | | 122.4% | | | 187.1% |

In addition to the outstanding commitments for use of liquidity displayed in the table above, the Bank will be utilizing approximately \$1.5 million over the next six to twelve months to complete the building of a new branch office in Haymarket, as well as move and expand its ViewTree branch office.

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.

CHANGES IN ACCOUNTING PRINCIPLES

In September 2006, the Emerging Issues Task Force (EITF) issued EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. This consensus concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with SFAS 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board (APB) Opinion No. 12 (if the arrangement is, in substance, an

Table of Contents

individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007, with early application permitted. The effect that EITF 06-4 had on the Company's consolidated financial statement of condition for September 30, 2008 was a reduction in retained earnings of \$12,000 and an increase in accrued benefit liabilities of \$19,000.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). This Statement requires that employers measure plan assets and obligations as of the balance sheet date. This requirement is effective for fiscal years ending after December 15, 2008. The other provisions of SFAS 158 were implemented by the Company as of December 31, 2006. The effect that this provision of SFAS 158 had on the Company's consolidated financial statement of condition for September 30, 2009 was a reduction in retained earnings of \$24,000 and an increase in accrued benefit liabilities of \$37,000.

RECENT ACCOUNTING POUNDCEMENTS

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), Business Combinations (SFAS 141(R)) (ASC 805 Business Combinations). The Standard significantly changed the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first year that begins after December 15, 2008. The Company does not expect the implementation of SFAS 141(R) to have a material impact on its (consolidated) financial statements, at this time.

In April 2009, the FASB issued FSP FAS 141(R)-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies (ASC 805 Business Combinations). FSP FAS 141(R)-1 amends and clarifies SFAS 141(R) to address application issues on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. The FSP is effective for assets and liabilities arising from contingencies in 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, 2008. The Company does not expect the adoption of FSP FAS 141(R)-1 to have a material impact on its (consolidated) financial statements.

In April 2009, the FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (ASC 820 Fair Value Measurements and Disclosures). FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with SFAS 157 when the volume and level of activity for the asset or liability have significantly decreased. The FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly. FSP FAS 157-4 is effective for interim and annual periods ending after June 15, 2009, and shall be applied prospectively. Earlier adoption is permitted for periods ending after March 15, 2009. The Company does not expect the adoption of FSP FAS 157-4 to have a material impact on its (consolidated) financial statements.

Table of Contents

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140 (ASC 860 Transfers and Servicing). SFAS 166 provides guidance to improve the relevance, representational faithfulness, and comparability of the information that a report 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. SFAS 166 is effective for interim and annual periods ending after November 15, 2009. The Company does not expect the adoption of SFAS 166 to have a material impact on its (consolidated) financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) (ASC 810 Consolidation). SFAS 167 improves financial reporting by enterprises involved with variable interest entities. SFAS 167 is effective for interim and annual periods ending after November 15, 2009. Early adoption is prohibited. The Company does not expect the adoption of SFAS 167 to have a material impact on its (consolidated) financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – replacement of FASB Statement No. 162 (ASC 105 Generally Accepted Accounting Principles). SFAS 168 establishes the FASB Accounting Standards Codification which will become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. SFAS 168 is effective immediately. The Company does not expect the adoption of SFAS 168 to have a material impact on its (consolidated) financial statements.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05 (ASU 2009-05), Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value. ASU 2009-05 amends Subtopic 820-10, Fair Value Measurements and Disclosures – Overall, and provides clarification for the fair value

Table of Contents

measurement of liabilities. ASU 2009-05 is effective for the first reporting period including interim period beginning after issuance. The Company does not expect the adoption of ASU 2009-05 to have a material impact on its (consolidated) financial statements.

In September 2009, the FASB issued Accounting Standards Update No. 2009-12 (ASU 2009-12), Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent). ASU 2009-12 provides guidance on estimating the fair value of alternative investments. ASU 2009-12 is effective for interim and annual periods ending after December 15, 2009. The Company does not expect the adoption of ASU 2009-12 to have a material impact on its (consolidated) financial statements.

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

In October 2009, the Securities and Exchange Commission issued Release No. 33-99072, Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers. Release No. 33-99072 delays the requirement for non-accelerated filers to include an attestation report of their independent auditor on internal control over financial reporting with their annual report until the fiscal year ending on or after June 15, 2010.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

There have been no material changes to the quantitative and qualitative disclosures made in the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

ITEM 4. CONTROLS AND PROCEDURES**Disclosure Controls and Procedures**

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

As of September 30, 2009, management has assessed the effectiveness of the internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the assessment, management determined that it maintained effective internal control over the financial reporting as of September 30, 2009, based on those criteria, and the Company's Chief Executive Officer and Chief Financial Officer can provide reasonable assurance regarding the reliability of financial reporting and the preparation of

Table of Contents

financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America.

Smith Elliott Kearns & Company, LLC, the independent registered public accounting firm that audited the Company's consolidated financial statements included in the Company's Annual Report on 10-K for the year ended December 31, 2008, has issued an attestation report on the effectiveness of Management's internal control over reporting as of December 31, 2008. The report, which states an unqualified opinion on the effectiveness of Management's internal control over financial reporting as of December 31, 2008, is incorporated by reference in the Company's Annual Report on 10-K for the year ended December 31, 2008 in Item 8 under the heading "Report of Independent Public Accounting Firm."

No changes were made in management's internal control over financial reporting during the quarter ended September 30, 2009 that have materially affected, or that are reasonably likely to materially affect, management's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors faced by the Company from those disclosed in Company's Annual Report on Form 10-K for the year ended December 31, 2008.

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

None. On January 15, 2009, the Board authorized the Company to repurchase up to 106,929 shares (3% of common stock outstanding on January 1, 2009) beginning January 1, 2009. No shares were repurchased during the nine months ended September 30, 2009.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

| Exhibit Number | Exhibit Description |
|-----------------------|---|
| 11 | Refer to Part I, Item 1, Note 6 to the Consolidated Financial Statements. |
| 31.1 | Certification of CEO pursuant to Rule 13a-14(a). |
| 31.2 | Certification of CFO pursuant to Rule 13a-14(a). |

Table of Contents

**Exhibit Exhibit
Number Description**

32.1 Certification of CEO pursuant to 18 U.S.C. Section 1350.

32.2 Certification of CFO pursuant to 18 U.S.C. Section 1350.

SIGNATURES

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

FAUQUIER BANKSHARES, INC.
(Registrant)

/s/ Randy K. Ferrell

Randy K. Ferrell
President & Chief Executive Officer
Dated: November 9, 2009

/s/ Eric P. Graap

Eric P. Graap
Executive Vice President & Chief Financial
Officer
Dated: November 9, 2009