

FAUQUIER BANKSHARES INC

Form 10-Q

August 13, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 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 June 30, 2007**

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)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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 3,548,258 shares of common stock outstanding as of August 10, 2007, the latest practicable date for determination.

FAUQUIER BANKSHARES, INC.
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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Balance Sheets

| | Unaudited June 30, 2007 | Audited December 31, 2006 |
|--|--|--|
| Assets | | |
| Cash and due from banks | \$ 13,359,554 | \$ 21,019,764 |
| Interest-bearing deposits in other banks | 538,881 | 537,891 |
| Federal funds sold | 5,244,000 | 20,122,000 |
| Securities available for sale | 38,270,457 | 40,352,775 |
| Loans, net of allowance for loan losses of \$4,407,421 in 2007 and \$4,470,533 in 2006 | 405,209,309 | 416,061,150 |
| Bank premises and equipment, net | 7,411,444 | 7,584,089 |
| Accrued interest receivable | 1,656,809 | 1,802,379 |
| Other assets | 14,337,960 | 14,282,097 |
| Total assets | \$ 486,028,414 | \$ 521,762,145 |
| Liabilities and Shareholders Equity | | |
| Deposits: | | |
| Noninterest-bearing | 78,031,178 | 85,495,160 |
| Interest-bearing | 332,119,816 | 330,576,258 |
| Total deposits | 410,150,994 | 416,071,418 |
| Federal funds purchased | | |
| Federal Home Loan Bank advances | 28,000,000 | 55,000,000 |
| Company-obligated mandatorily redeemable capital securities | 4,124,000 | 8,248,000 |
| Other liabilities | 3,523,498 | 3,730,778 |
| Commitments and contingencies | | |
| Total liabilities | 445,798,492 | 483,050,196 |
| Shareholders Equity | | |
| Common stock, par value, \$3.13; authorized 8,000,000 shares: issued and outstanding, 2007: 3,545,138 shares (includes nonvested shares of 31,190); 2006: 3,478,960 shares (includes nonvested shares of 31,829) | 10,998,657 | 10,789,521 |
| Retained earnings | 30,285,643 | 28,962,409 |
| Accumulated other comprehensive income (loss), net | (1,054,378) | (1,039,981) |
| Total shareholders equity | 40,229,922 | 38,711,949 |

| | | |
|--|----------------|----------------|
| Total liabilities and shareholders' equity | \$ 486,028,414 | \$ 521,762,145 |
|--|----------------|----------------|

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)
For the Three Months Ended June 30, 2007 and 2006

| | 2007 | 2006 |
|--|---------------|---------------|
| Interest Income | | |
| Interest and fees on loans | \$ 7,233,485 | \$ 6,905,346 |
| Interest and dividends on securities available for sale: | | |
| Taxable interest income | 363,447 | 395,485 |
| Interest income exempt from federal income taxes | 16,291 | 13,129 |
| Dividends | 92,907 | 74,847 |
| Interest on federal funds sold | 23,951 | 2,763 |
| Interest on deposits in other banks | 15,872 | 6,303 |
| Total interest income | 7,745,953 | 7,397,873 |
| Interest Expense | | |
| Interest on deposits | 2,542,648 | 1,846,576 |
| Interest on federal funds purchased | 51,602 | 166,650 |
| Interest on Federal Home Loan Bank advances | 378,656 | 394,625 |
| Distribution on capital securities of subsidiary trusts | 71,341 | 87,018 |
| Total interest expense | 3,044,247 | 2,494,869 |
| Net interest income | 4,701,706 | 4,903,004 |
| Provision for loan losses | 120,000 | 180,000 |
| Net interest income after provision for loan losses | 4,581,706 | 4,723,004 |
| Other Income | | |
| Wealth management income | 354,685 | 336,334 |
| Service charges on deposit accounts | 717,525 | 723,513 |
| Other service charges, commissions and income | 440,859 | 373,063 |
| Total other income | 1,513,069 | 1,432,910 |
| Other Expenses | | |
| Salaries and benefits | 2,313,208 | 2,321,056 |
| Net occupancy expense of premises | 265,177 | 262,648 |
| Furniture and equipment | 296,109 | 347,787 |
| Advertising expense | 161,692 | 166,569 |
| Consulting expense | 193,948 | 233,265 |

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| | | |
|--|--------------|--------------|
| Data processing expense | 312,860 | 281,827 |
| Other operating expenses | 722,055 | 702,255 |
| Total other expenses | 4,265,049 | 4,315,407 |
| Income before income taxes | 1,829,726 | 1,840,507 |
| Income tax expense | 550,295 | 552,695 |
| Net Income | \$ 1,279,431 | \$ 1,287,812 |
| Earnings per Share, basic | \$ 0.36 | \$ 0.37 |
| Earnings per Share, assuming dilution | \$ 0.36 | \$ 0.36 |
| Dividends per Share | \$ 0.200 | \$ 0.190 |

See accompanying Notes to Consolidated Financial Statements.

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Consolidated Statements of Income
(Unaudited)
For the Six Months Ended June 30, 2007 and 2006

| | 2007 | 2006 |
|--|----------------|----------------|
| Interest Income | | |
| Interest and fees on loans | \$ 14,511,990 | \$ 13,328,784 |
| Interest and dividends on securities available for sale: | | |
| Taxable interest income | 735,452 | 813,322 |
| Interest income exempt from federal income taxes | 29,488 | 26,252 |
| Dividends | 143,404 | 121,995 |
| Interest on federal funds sold | 66,551 | 17,405 |
| Interest on deposits in other banks | 20,662 | 11,278 |
| Total interest income | 15,507,547 | 14,319,036 |
| Interest Expense | | |
| Interest on deposits | 4,961,275 | 3,417,674 |
| Interest on federal funds purchased | 138,445 | 204,450 |
| Interest on Federal Home Loan Bank advances | 903,604 | 882,437 |
| Distribution on capital securities of subsidiary trusts | 227,442 | 172,723 |
| Total interest expense | 6,230,766 | 4,677,284 |
| Net interest income | 9,276,781 | 9,641,752 |
| Provision for loan losses | 240,000 | 300,000 |
| Net interest income after provision for loan losses | 9,036,781 | 9,341,752 |
| Other Income | | |
| Wealth management income | 693,558 | 663,881 |
| Service charges on deposit accounts | 1,377,316 | 1,359,452 |
| Other service charges, commissions and income | 864,997 | 725,405 |
| Gain on cancellation of property rights | | 250,000 |
| Loss on sale of securities | | (82,564) |
| Total other income | 2,935,871 | 2,916,174 |
| Other Expenses | | |
| Salaries and benefits | 4,661,441 | 4,504,823 |
| Net occupancy expense of premises | 533,283 | 503,801 |
| Furniture and equipment | 583,709 | 679,506 |
| Advertising expense | 282,093 | 264,833 |

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| | | |
|---|--------------|--------------|
| Consulting expense | 433,890 | 527,260 |
| Data processing expense | 612,541 | 553,513 |
| Other operating expenses | 1,347,271 | 1,386,762 |
| Total other expenses | 8,454,228 | 8,420,498 |
| Income before income taxes | 3,518,424 | 3,837,428 |
| Income tax expense | 1,066,513 | 1,152,004 |
| Net Income | \$ 2,451,911 | \$ 2,685,424 |
| Earnings per Share , basic | \$ 0.70 | \$ 0.77 |
| Earnings per Share , assuming dilution | \$ 0.69 | \$ 0.75 |
| Dividends per Share | \$ 0.390 | \$ 0.365 |

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders Equity
(Unaudited)
For the Six Months Ended June 30, 2007 and 2006

| | Common | Retained | Accumulated Other Comprehensive Income | Comprehensive | |
|--|---------------|-----------------|---|----------------------|---------------|
| | Stock | Earnings | (Loss) | Income | Total |
| Balance, December 31, 2005 | \$ 10,794,700 | \$ 25,440,838 | \$ (656,393) | | \$ 35,579,145 |
| Comprehensive income: | | | | | |
| Net income | | 2,685,424 | | \$ 2,685,424 | 2,685,424 |
| Other comprehensive income (loss) net of tax: | | | | | |
| Unrealized holding losses on securities available for sale, net of deferred income taxes of \$120,771 | | | (234,437) | | |
| Add: reclassification adjustment, net of tax of \$28,072 | | | 54,492 | | |
| Other comprehensive income (loss) net of tax: | | | (179,945) | (179,945) | |
| Total comprehensive income | | | | 2,505,479 | |
| Cash dividends (\$.365 per share) | | (1,268,073) | | | (1,268,073) |
| SFAS No. 123(R) implementation adjustment | (67,238) | 67,238 | | | |
| Amortization of unearned compensation, restricted stock awards | | 102,879 | | | 102,879 |
| Issuance of common stock | 10,993 | 75,688 | | | 86,681 |
| Exercise of stock options | 38,937 | 26,760 | | | 65,697 |
| Balance, June 30, 2006 | \$ 10,777,392 | \$ 27,130,754 | \$ (836,338) | | \$ 37,251,753 |
| Balance, December 31, 2006 | \$ 10,789,521 | \$ 28,962,409 | \$ (1,039,981) | | \$ 38,711,949 |
| Comprehensive income: | | | | | |
| Net income | | 2,451,911 | | \$ 2,451,911 | 2,451,911 |
| Other comprehensive income (loss) net of tax: | | | | | |
| Unrealized holding losses on securities available for sale, | | | (14,397) | (14,397) | (14,397) |

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net of deferred income taxes
of \$7,418

| | | | | |
|--|---------------|---------------|----------------|---------------|
| Total comprehensive income | | | | 2,437,514 |
| Cash dividends (\$.39 per share) | | (1,380,939) | | (1,380,939) |
| Acquisition of 8,270 shares of common stock | (25,886) | (180,955) | | (206,841) |
| Amortization of unearned compensation, restricted stock awards | | 127,140 | | 127,140 |
| Issuance of common stock nonvested shares (11,437 shares) | 35,797 | (35,797) | | |
| Exercise of stock options | 199,224 | 341,874 | | 541,098 |
| Balance, June 30, 2007 | \$ 10,998,656 | \$ 30,285,643 | \$ (1,054,378) | \$ 40,229,922 |

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)
For the Six Months Ended June 30, 2007 and 2006

| | 2007 | 2006 |
|---|--------------|--------------|
| Cash Flows from Operating Activities | | |
| Net income | \$ 2,451,911 | \$ 2,685,424 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 518,956 | 604,154 |
| Provision for loan losses | 240,000 | 300,000 |
| Amortization (accretion) of security premiums, net | (2,798) | 14,830 |
| Amortization of unearned compensation | 127,140 | 102,879 |
| Changes in assets and liabilities: | | |
| Decrease in other assets | 97,126 | 622,964 |
| Decrease in other liabilities | (207,280) | (107,939) |
| Net cash provided by operating activities | 3,225,055 | 4,222,312 |
| Cash Flows from Investing Activities | | |
| Proceeds from sale of securities available for sale | | 3,024,745 |
| Proceeds from maturities, calls and principal payments of securities available for sale | 1,997,343 | 2,150,247 |
| Purchase of securities available for sale | (1,093,743) | |
| Proceeds from sale of premises and equipment | | |
| Purchase of premises and equipment | (346,311) | (316,954) |
| Proceeds from sale of other bank stock | 1,159,700 | 391,100 |
| Net decrease (increase) in loans | 10,611,841 | (31,888,840) |
| Net cash provided by (used in) investing activities | 12,328,830 | (26,639,702) |
| Cash Flows from Financing Activities | | |
| Net (decrease) increase in demand deposits, NOW accounts and savings accounts | 9,571,507 | (15,411,318) |
| Net (decrease) increase in certificates of deposit | (15,491,931) | 27,059,281 |
| Federal Home Loan Bank advances | 25,000,000 | |
| Federal Home Loan Bank principal repayments | (52,000,000) | (11,000,000) |
| Purchase of federal funds | | 12,000,000 |
| Repayment of trust preferred securities | (4,124,000) | |
| Cash dividends paid on common stock | (1,380,939) | (1,268,073) |
| Issuance of common stock | 541,098 | 152,376 |
| Acquisition of common stock | (206,841) | |
| Net cash provided by (used in) financing activities | (38,091,106) | 11,532,266 |

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| | | |
|--|---------------|---------------|
| (Decrease) in cash and cash equivalents | (22,537,221) | (10,885,124) |
| Cash and Cash Equivalents | | |
| Beginning | 41,679,655 | 27,738,715 |
| Ending | \$ 19,142,434 | \$ 16,853,591 |
| Supplemental Disclosures of Cash Flow Information | | |
| Cash payments for: | | |
| Interest | \$ 5,017,141 | \$ 3,251,617 |
| Income taxes | \$ 720,000 | \$ 808,000 |
| Supplemental Disclosures of Noncash Investing Activities | | |
| Unrealized gain (loss) on securities available for sale, net of tax effect | \$ (14,397) | \$ 272,644 |

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

1. General

The consolidated statements include the accounts of Fauquier Bankshares, Inc. (the Company) and its wholly-owned subsidiary, The Fauquier Bank (the Bank), and the Bank's wholly-owned subsidiary, Fauquier Bank Services, Inc. In consolidation, significant intercompany financial balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial positions as of June 30, 2007 and December 31, 2006 and the results of operations for the three and six months ended June 30, 2007 and 2006. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's 2006 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The results of operations for the three and six months ended June 30, 2007 and 2006 are not necessarily indicative of the results expected for the full year.

2. Securities

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|--|-------------------|------------------------------|---------------------------------|---------------|
| June 30, 2007 | | | | |
| Obligations of U.S. Government corporations and agencies | \$ 27,529,304 | \$ 1,175 | \$ (588,536) | \$ 26,941,943 |
| Obligations of states and political subdivisions | 2,056,557 | 36,142 | (35,055) | 2,057,644 |
| Corporate Bonds | 6,000,000 | 50,000 | (21,250) | 6,028,750 |
| Mutual Funds | 285,431 | | (13,531) | 271,900 |
| FHLMC Preferred Bank Stock | 441,000 | | (10,000) | 431,000 |
| Restricted investments: | | | | |
| Federal Home Loan Bank Stock | 2,277,300 | | | 2,277,300 |
| Federal Reserve Bank Stock | 99,000 | | | 99,000 |
| Community Bankers Bank Stock | 50,000 | | | 50,000 |
| The Bankers Bank Stock | 112,920 | | | 112,920 |
| | \$ 38,851,512 | \$ 87,317 | \$ (668,372) | \$ 38,270,457 |

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|--|-------------------|------------------------------|---------------------------------|---------------|
| December 31, 2006 | | | | |
| Obligations of U.S. Government corporations and agencies | \$ 29,529,836 | \$ 2,029 | \$ (599,698) | \$ 28,932,167 |
| Obligations of states and political subdivisions | 962,814 | 48,740 | | 1,011,554 |
| Corporate Bonds | 6,000,000 | 27,500 | (42,500) | 5,985,000 |

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| | | | | |
|------------------------------|---------------|-----------|--------------|---------------|
| Mutual Funds | 279,445 | | (9,311) | 270,134 |
| FHLMC Preferred Bank Stock | 441,000 | 14,000 | | 455,000 |
| Restricted investments: | | | | |
| Federal Home Loan Bank Stock | 3,437,000 | | | 3,437,000 |
| Federal Reserve Bank Stock | 99,000 | | | 99,000 |
| Community Bankers Bank Stock | 50,000 | | | 50,000 |
| The Bankers Bank Stock | 112,920 | | | 112,920 |
| | \$ 40,912,015 | \$ 92,269 | \$ (651,509) | \$ 40,352,775 |

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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.

| | June 30, 2007 | |
|--|----------------|---------------|
| | Amortized Cost | Fair Value |
| Due in one year or less | \$ 11,752,532 | \$ 11,572,212 |
| Due after one year through five years | 22,633,240 | 22,295,017 |
| Due after five years through ten years | 517,960 | 502,458 |
| Due after ten years | 682,129 | 658,650 |
| Equity securities | 3,265,651 | 3,242,120 |
| | \$ 38,851,512 | \$ 38,270,457 |

The following table shows the Company's investments with gross unrealized losses and their fair value, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position at June 30, 2007 and December 31, 2006.

| June 30, 2007 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 | \$ 4,032 | \$ (2) | \$ 26,803,622 | \$ (588,534) | \$ 26,807,654 | \$ (588,536) |
| Corporate Bonds | | | 1,978,750 | (21,250) | 1,978,750 | (21,250) |
| Obligations of states and political subdivisions | 1,058,015 | (35,055) | | | 1,058,015 | (35,055) |
| Subtotal, debt securities | 1,062,047 | (35,057) | 28,782,372 | (609,784) | 29,844,419 | (644,841) |
| Mutual Funds | | | 271,900 | (13,531) | 271,900 | (13,531) |
| FHLMC Preferred Bank Stock | 441,000 | (10,000) | | | 441,000 | (10,000) |
| Total temporary impaired securities | \$ 1,503,047 | \$ (45,057) | \$ 29,054,272 | \$ (623,315) | \$ 30,557,319 | \$ (668,372) |

| December 31, 2006 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 | \$ | \$ | \$ 28,734,320 | \$ (599,698) | \$ 28,734,320 | \$ (599,698) |
| Corporate Bonds | | | 3,957,500 | (42,500) | 3,957,500 | (42,500) |
| Mutual Funds | | | 279,445 | (9,311) | 279,445 | (9,311) |
| Total temporary impaired securities | \$ | \$ | \$ 32,971,265 | \$ (651,509) | \$ 32,971,265 | \$ (651,509) |

The nature of securities which are temporarily impaired for a continuous 12 months or more can be segregated into three groups. The first group consists of Federal Agency bonds totaling \$26.8 million with a temporary loss of \$588,536. The bonds within this group have Aaa/AAA ratings from Moody's and Standard & Poors, respectively. These bonds have estimated maturity dates of 18 months to 33 months. The Company has the ability to hold these bonds to maturity.

The second group consists of corporate bonds, rated A2 by Moody's, totaling \$2.0 million with a temporary loss of \$21,250. These bonds have an estimated maturity of 27 years but can be called at par on their five year anniversary. If not called, the bonds reprice every three months at a fixed rate index above LIBOR. The Company has the ability to hold these bonds to maturity.

The third group consists of a Community Reinvestment Act qualified investment bond fund with a temporary loss of \$13,531. The fund is a relatively small portion of the portfolio and the Company plans to hold it indefinitely.

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$15,452,563 and \$15,533,390 at June 30, 2007 and December 31, 2006, respectively.

3. Loans

A summary of the balances of loans follows:

| | June 30, 2007 | December 31, 2006 |
|--|--------------------------|----------------------------------|
| | (Thousands) | |
| Real estate loans: | | |
| Construction | \$ 33,696 | \$ 33,662 |
| Secured by farmland | 1,372 | 1,365 |
| Secured by 1-to-4 family residential | 171,163 | 168,310 |
| Other real estate loans | 127,189 | 134,955 |
| Commercial and industrial loans (not secured by real estate) | 39,867 | 41,508 |
| Consumer installment loans | 28,217 | 31,952 |
| All other loans | 8,495 | 9,273 |
| Total loans | \$ 409,999 | \$ 421,025 |
| Unearned income | (382) | (493) |
| Allowance for loan losses | (4,407) | (4,471) |
| Net loans | \$ 405,210 | \$ 416,061 |

Analysis of the allowance for loan losses follows:

| | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 | Twelve Months Ended December 31, 2006 |
|--|--|--|--|
| Balance at beginning of period | \$ 4,470,533 | \$ 4,238,143 | \$ 4,238,143 |
| Provision for loan losses | 240,000 | 300,000 | 360,000 |
| Recoveries of loans previously charged-off | 21,542 | 48,347 | 128,463 |
| Loan losses charged-off | (324,654) | (128,520) | (256,073) |
| Balance at end of period | \$ 4,407,421 | \$ 4,457,970 | \$ 4,470,533 |

Nonperforming assets consist of the following:

| June 30, | December 31, |
|---------------------|-------------------------|
|---------------------|-------------------------|

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| | 2007 | 2006 |
|-----------------------------------|-----------------|-----------------|
| | (Thousands) | |
| Nonaccrual loans | \$ 724 | \$ 1,608 |
| Restructured loans | | |
| Total nonperforming loans | 724 | 1,608 |
| Foreclosed property | 284 | 140 |
| Total nonperforming assets | \$ 1,008 | \$ 1,748 |

Total loans past due 90 days and still accruing interest totaled \$1,000 on June 30, 2007 and December 31, 2006.

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4. Company-Obligated Mandatorily Redeemable Capital Securities of Subsidiary Trusts

On September 21, 2006, the Company's wholly-owned Connecticut statutory business trust privately issued \$4.0 million face amount of the trust's Floating Rate Capital Securities in a pooled capital securities offering. 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 securities resets every three months at 1.70% above the then current three month LIBOR. Interest is paid quarterly.

Total capital securities at June 30, 2007 were \$4,124,000. The 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.

The purpose of the September 2006 issuance was to use the proceeds to redeem \$4.0 million of capital securities previously issued on March 26, 2002. Because of changes in the market pricing of capital securities from 2002 to 2006, the September 2006 issuance is priced 190 basis points less than that of the March 2002 issuance; therefore the 2002 issuance was redeemed on March 26, 2007.

5. Earnings per Share

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

| | Three Months Ended June 30, 2007 | | Three Months Ended June 30, 2006 | |
|---|---|-------------------------|---|-------------------------|
| | Shares | Per Share Amount | Shares | Per Share Amount |
| Basic earnings per share | 3,515,669 | \$ 0.36 | 3,475,064 | \$ 0.37 |
| Effect of dilutive securities, stock-based awards | 71,979 | | 112,986 | |
| | 3,587,648 | \$ 0.36 | 3,588,050 | \$ 0.36 |

| | Six Months Ended June 30, 2007 | | Six Months Ended June 30, 2006 | |
|---|---|-------------------------|---|-------------------------|
| | Shares | Per Share Amount | Shares | Per Share Amount |
| Basic earnings per share | 3,503,359 | \$ 0.70 | 3,466,540 | \$ 0.77 |
| Effect of dilutive securities, stock-based awards | 72,694 | | 112,686 | |
| | 3,576,053 | \$ 0.69 | 3,579,226 | \$ 0.75 |

6. Stock-Based Compensation

At June 30, 2007, the Company has a stock-based compensation plan. Effective January 1, 2006 the Company adopted the provisions of FASB Statement 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 nonvested shares are accounted for using the fair market value of the Company's common stock on the date the restricted shares were awarded. The restricted shares issued to executive officers and directors are subject to a vesting period, whereby, the restrictions on one-third of the shares lapse on the anniversary of the date the restricted shares were awarded over the next three years. Compensation expense for nonvested shares amounted to \$64,545 and \$58,694 for the three months ended June 30, 2007 and 2006, respectively.

Compensation expense for nonvested shares amounted to \$127,140 and \$102,879 for the six months ended June 30, 2007 and 2006, respectively.

The Company did not grant options during the six months ended June 30, 2007 and 2006.

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

| | | Six Months Ended June 30, 2007 | |
|---|---------------------------------|--|--|
| | Number of Shares | Weighted Average Exercise Price | Average Intrinsic Value (1) |
| Outstanding at January 1, Granted | 177,466 | \$ 9.50 | |
| Exercised | (63,650) | 8.50 | |
| Forfeited | | | |
| Outstanding at June 30, | 113,816 | \$ 10.06 | \$ 1,695,858 |
| Exercisable at end of quarter | 113,816 | | \$ 1,695,858 |
| Weighted-average fair value per option of options granted during the year | | \$ | |

(1) The aggregate intrinsic value of stock options in the table above reflects the pre-tax intrinsic value (the amount by which the June 30, 2007 market value of the underlying stock option

exceeded the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on June 30, 2007. This amount changes based on the changes in the market value of the Company's stock.

The total intrinsic value of options exercised during the six months ended June 30, 2007 and 2006 was \$1,065,008 and \$240,888, respectively.

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

| | Six Months Ended June 30, 2007 | Weighted Average Grant Date Fair Value (per Share) |
|-------------------------|---|---|
| | Number of Shares | |
| Nonvested at January 1, | 31,829 | |
| Granted | 10,798 | \$ 25.40 |
| Vested | (11,437) | |
| Forfeited | | |
| Nonvested at June 30, | 31,190 | |

As of June 30, 2007, there was \$427,758 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted average period of three years.

7. Employee Benefit Plan

The following table provides a reconciliation of the changes in the defined benefit pension plan's obligations for the three and six months ended June 30, 2007 and 2006.

| | Three Months Ended June 30, | |
|------------------------------------|--|-------------|
| | 2007 | 2006 |
| Service cost | \$ 167,680 | \$ 173,127 |
| Interest cost | 100,343 | 93,997 |
| Expected return on plan assets | (111,378) | (98,960) |
| Amortization of transition (asset) | 1,942 | (4,745) |
| Amortization of prior service cost | (4,745) | 1,942 |
| Recognized net actuarial loss | 5,258 | 15,239 |
| Net periodic benefit cost | \$ 159,100 | \$ 180,600 |

| | Six Months Ended June 30, | |
|------------------------------------|--------------------------------------|-------------|
| | 2007 | 2006 |
| Service cost | \$ 335,360 | \$ 346,254 |
| Interest cost | 200,686 | 187,994 |
| Expected return on plan assets | (222,756) | (197,920) |
| Amortization of transition (asset) | 3,884 | (9,490) |
| Amortization of prior service cost | (9,490) | 3,884 |
| Recognized net actuarial loss | 10,516 | 30,478 |

| | | |
|---------------------------|------------|------------|
| Net periodic benefit cost | \$ 318,200 | \$ 361,200 |
|---------------------------|------------|------------|

The Company previously disclosed in its financial statements for the year ended December 31, 2006, that it contributed \$1,634,468 to its pension plan in 2006. As of June 30, 2007, the pension plan requires no additional contributions.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

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 are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, 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 (Federal Reserve), the quality or composition of the Bank's loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area, our plans to expand our branch network and increase our market share, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating the forward-looking statements in this report, and you should not place undue reliance on such statements, which reflect our position as of the date of this report.

GENERAL

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 3,545,138 shares of common stock, par value \$3.13 per share, held by approximately 440 holders of record on June 30, 2007. The Bank has eight full service branch offices located in the Virginia communities of Warrenton, Catlett, The Plains, Sudley Road-Manassas, Old Town-Manassas, New Baltimore, and Bealeton. 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 a property in Haymarket, Virginia, where it plans to build its ninth full-service branch office scheduled to open during the first quarter of 2008.

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 and businesses. The deposits of the Bank are insured up to applicable limits by the Bank Insurance Fund of the Federal Deposit Insurance Fund.

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, traveler's checks, cashier's checks, domestic collections, savings bonds, bank drafts, automated teller services, drive-in tellers, internet banking, telephone banking, and banking by mail. In addition, the Bank makes secured and unsecured commercial and real estate loans, issues stand-by letters of credit and grants available credit for installment, unsecured and secured personal loans, residential mortgages and home equity loans, as well as automobile and other types of consumer financing. The Bank provides automated teller machine (ATM) cards, as a part of the Star, NYCE, and Plus ATM networks, thereby permitting customers to utilize the convenience of larger ATM networks.

The Bank operates a Wealth Management Services (WMS) 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. Assets managed by WMS increased by \$9.0 million to \$303.7 million on June 30, 2007, or 3.0%, when compared with June 30, 2006, with revenue increasing from \$336,000 to \$355,000 or 5.5%, for the same respective second quarters of 2006 and 2007.

The Bank, through its subsidiary Fauquier Bank Services, Inc., has equity ownership interests in Bankers Insurance, LLC, a Virginia independent insurance company; Bankers Investments Group, LLC, a full service broker/dealer; and Bankers Title Shenandoah, LLC, a title insurance company. Bankers Insurance consists of a consortium of 54 Virginia community bank owners; Bankers Investments Group is owned by 32 Virginia and Maryland community banks; and Bankers Title Shenandoah is owned by 11 Virginia community banks.

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

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

As of June 30, 2007, the Company had total consolidated assets of \$486.0 million, total loans net of allowance for loan losses of \$405.2 million, total consolidated deposits of \$410.2 million, and total consolidated shareholders' equity of \$40.2 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 financial 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 financial statements 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) Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, (ii) 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) U.S. Securities and Exchange Commission 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-to-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, and industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in the specific allowance.

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

Net income for the quarter ended June 30, 2007 was \$1.28 million, a 0.7% decrease from the net income of \$1.29 million for the quarter ended June 30, 2006. Net interest income declined \$201,000 during the second quarter of 2007 compared to the same period one year earlier. This was largely offset by an \$80,000 increase in other income as well as decreases of \$60,000 in provision for loan losses and \$50,000 in other expenses.

Net income for the six month period ended June 30, 2007 was \$2.45 million, an 8.7% decrease from the net income of \$2.69 million for the six month period ended June 30, 2006. The comparative decline in net income for the six month periods was primarily due to the absence in 2007 of the one-time \$250,000 pre-tax gain on the cancellation of a property usage contract experienced in the first quarter of 2006. In addition, net interest income declined \$365,000 during the first six months of 2007 compared to the same period one year earlier.

Net loans and total deposits were \$405.2 million and \$410.2 million, respectively, at June 30, 2007, a decrease of 1.8% and an increase of 1.7%, respectively, since June 30, 2006. WMS assets under management grew 3.0% from June 30, 2006 to June 30, 2007.

Net interest income is the largest component of net income, and equals the difference between income generated on interest-earning assets and interest expense incurred on interest-bearing liabilities. Future trends regarding net interest income are dependent on the absolute level of market interest rates, the shape of the yield curve, the amount of lost income from non-performing assets, the amount of prepaying loans, the mix and amount of various deposit types, and many other factors, as well as the overall volume of interest-earning assets. These factors are individually difficult to predict, and when taken together, the uncertainty of future trends compounds. Based on management's current projections, net interest income may increase during the remainder of 2007 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 a flat or inverted yield curve. Additionally, the Bank's balance sheet

is positioned for a stable or rising interest rate environment. This means that net interest income is projected to increase if market interest rates rise, and to decrease if market interest rates fall, assuming no change in the shape of the interest rate yield curve. A steeper yield curve is projected to result in an increase in net interest income, while a flatter or inverted yield curve is projected to result in a decrease in net interest income. The specific nature of the Bank's variability in net interest income due to changes in interest rates, also known as interest rate risk, is to a large degree the result of the Bank's deposit base structure. For the quarter ended June 30, 2007, demand deposits, NOW accounts, and savings deposits averaged 19%, 18%, and 8% of total average deposits, respectively, while the more interest-rate sensitive premium money market accounts, money market accounts, and certificates of deposit averaged 17%, 6% and 32% of total average deposits, respectively.

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The Bank continues to have strong credit quality as evidenced by nonperforming assets totaling \$1.01 million or 0.25% of total loans at June 30, 2007, as compared with \$1.75 million, or 0.42% of total loans at December 31, 2006, and \$1.76 million or 0.42% at June 30, 2006. The provision for loan losses was \$120,000 for the second quarter of 2007 compared with \$180,000 for the second quarter of 2006. Loan chargeoffs, net of recoveries, totaled \$303,000, or 0.07% of total loans for the first six months of 2007, compared with \$80,000 or 0.02% of total loans for the first six months of 2006. The decrease in the provision for loan losses for the second quarter of 2007 compared with the second quarter of 2006 was largely in response to the decrease in nonperforming loans during the second quarter of 2007, as well as the slowdown in new loan originations during the last six months, partially offset by the increase in net loan chargeoffs.

Management seeks to continue the expansion of its branch network. The Bank looks to add to its branch network in western Prince William County beyond the addition of a retail branch office in Haymarket during the first quarter of 2008. The Bank is looking toward these new retail markets for growth in deposits and WMS income. Management also seeks to increase the level of its fee income from deposits and WMS through the increase of its market share within its current marketplace.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2007 AND JUNE 30, 2006

NET INCOME. Net income for the three months ended June 30, 2007 was \$1.28 million or \$0.36 per diluted share compared with \$1.29 million or \$0.36 per diluted share for the three months ended June 30, 2006. The decline in net income of 0.7% for the second quarter of 2007 versus the second quarter of 2006 was primarily due to the \$201,000 decrease in net interest income in the second quarter of 2007 versus the second quarter of 2006, largely offset by an \$80,000 increase in other income, as well as decreases of \$60,000 in provision for loan losses and \$50,000 in other expenses.

NET INTEREST INCOME. Net interest income decreased \$201,000 or 4.1% to \$4.70 million for the three months ended June 30, 2007 compared with \$4.90 million for the three months ended June 30, 2006. The decrease in net interest income resulted from the decrease in the net interest margin. Computed on a tax equivalent basis, the net interest margin for the June 2007 quarter was 4.12%, compared with 4.34% for the same quarter one year earlier. The primary reasons for the decrease in the net interest margin are the impact of the inversion of yield curve from July 2006 through June 2007, coupled with competitive pressures on the pricing of interest-earning assets and interest-bearing liabilities. In an inverted yield curve, the interest rates on shorter-term debt instruments exceed the interest rates on longer-term debt instruments. The impact of the declining net interest margin was partially offset by a 0.7% increase in total average earning assets from \$451.3 million during the second quarter of 2006 to \$454.3 million for the second quarter of 2007.

The yield on average interest-earning assets on a tax equivalent basis was 6.81% for the June 2007 quarter compared with 6.55% for the June 2006 quarter. Total interest income increased \$348,000 or 4.7% to \$7.75 million for the three months ended June 30, 2007, compared with \$7.40 million for the three months ended June 30, 2006, as a result of the growth in the volume of interest-earning assets and in the average rate of interest earned. Interest and dividends on investment securities decreased \$11,000 or 2.2%. Investment securities averaged \$38.2 million for the second quarter of 2007 compared with \$43.3 million for the same quarter one year earlier. The yield on investment securities was 5.03% on a tax equivalent basis for the second quarter of 2007, compared with 4.52% for the second quarter of 2006. Interest and fees on loans increased \$328,000 or 4.8% to \$7.23 million for the June 2007 quarter compared with \$6.91 million for the same quarter one year earlier. Average loans outstanding totaled \$413.1 million and earned 6.98% on a tax-equivalent basis for the quarter ended June 30, 2007, compared with \$406.9 million and 6.77%, respectively, for the quarter ended June 30, 2006.

Total interest expense increased \$549,000 or 22.0% to \$3.04 million for the three months ended June 30, 2007 from \$2.49 million for the three months ended June 30, 2006. Average interest-bearing liabilities grew 3.2% to \$367.5 million for the second quarter of 2007 compared with \$356.1 million for the second quarter of 2006, while the average cost on interest-bearing liabilities increased to 3.32% from 2.80% for the same respective time periods. The increase in total interest expense and the average cost of interest-bearing liabilities is primarily due to the overall increase in short-term interest rates, as well as significantly increased balances in higher cost funding sources such as the premium interest rate money market account and time deposits. The average balance for the premium interest rate money market account was \$70.0 million with an average cost of 4.15% for the three months ended June 30, 2007 compared with \$50.5 million with an average cost of 3.88% for the three months ended June 30, 2006. Average time deposit balances for the second quarter of 2007 were \$129.6 million at an average cost of 4.53%, compared with \$115.3 million at an average cost of 3.88% for the same quarter one year earlier. Interest-bearing NOW account deposits averaged \$72.3 million at an average cost of 1.27% for the June 2007 quarter, compared with \$66.6 million at an average cost of 0.47% for the June 2006 quarter. Other interest-bearing money market deposits averaged \$26.1 million at an average cost of 1.41% for the quarter ended June 30, 2007, compared with \$38.6 million at an average cost of 1.38% for the same quarter one year earlier. Savings account deposits averaged \$33.3 million at an average cost of 0.41% for the June 2007 quarter, compared with \$38.6 million at an average cost of 0.34% for the June 2006 quarter. Average FHLB of Atlanta advances were \$28.5 million at an average cost of 5.26% for the second quarter of 2007, and \$30.2 million at an average cost of 5.17% one year earlier. Capital securities of the subsidiary trust averaged \$4.1 million at an average cost of 6.84% for the June 2007 quarter, compared with \$4.1 million at an average cost of 8.35% for the June 2006 quarter.

The following table sets forth information relating to the Company's average balance sheet and reflects the average yield on assets and the average annualized cost of liabilities for the three-month periods ended June 30, 2007 and 2006. These yields and costs are derived by annualizing the income or expense for the periods presented, and dividing the product of the annualization by the respective average daily balances of assets and liabilities for the periods presented.

AVERAGE BALANCES, INCOME AND EXPENSES, AND AVERAGE YIELDS AND RATES
(In Thousands)

| | Three Months Ended June 30, 2007 | | | Three Months Ended June 30, 2006 | | |
|---|----------------------------------|--------------------|-----------------|----------------------------------|--------------------|-----------------|
| | Average Balances | Income/ Expense | Average Rate | Average Balances | Income/ Expense | Average Rate |
| ASSETS: | | | | | | |
| Loans | | | | | | |
| Taxable | \$ 403,856 | \$ 7,142 | 7.00% | \$ 397,433 | \$ 6,806 | 6.78% |
| Tax-exempt (1) | 7,711 | 140 | 7.18% | 8,390 | 151 | 7.10% |
| Nonaccrual | 1,569 | | | 1,114 | | |
| Total Loans | 413,136 | 7,282 | 6.98% | 406,937 | 6,957 | 6.77% |
| Securities | | | | | | |
| Taxable | 36,930 | 456 | 4.94% | 42,322 | 470 | 4.45% |
| Tax-exempt (1) | 1,290 | 25 | 7.65% | 1,016 | 20 | 7.75% |
| Total securities | 38,220 | 481 | 5.03% | 43,338 | 490 | 4.52% |
| Deposits in banks | 1,061 | 16 | 5.96% | 622 | 6 | 4.01% |
| Federal funds sold | 1,869 | 24 | 5.07% | 397 | 3 | 2.75% |
| Total earning assets | 454,286 | 7,803 | 6.81% | 451,294 | 7,456 | 6.55% |
| Less: Reserve for loan losses | (4,512) | | | (4,369) | | |
| Cash and due from banks | 15,820 | | | 16,368 | | |
| Bank premises and equipment, net | 7,479 | | | 8,136 | | |
| Other assets | 15,556 | | | 14,823 | | |
| Total Assets | \$ 488,629 | | | \$ 486,252 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY: | | | | | | |
| Deposits | | | | | | |
| Demand deposits | \$ 77,103 | | | \$ 90,285 | | |
| Interest-bearing deposits | | | | | | |
| NOW accounts | 72,261 | 229 | 1.27% | 66,620 | 85 | 0.47% |
| Money market accounts | 26,063 | 92 | 1.41% | 38,634 | 133 | 1.38% |
| Premium money market accounts | 70,049 | 724 | 4.15% | 50,522 | 489 | 3.88% |
| Savings accounts | 33,287 | 34 | 0.41% | 38,612 | 33 | 0.34% |
| Time deposits | 129,551 | 1,464 | 4.53% | 115,328 | 1,114 | 3.88% |

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| | | | | | | |
|---|------------|----------|-------|------------|----------|-------|
| Total interest-bearing deposits | 331,211 | 2,543 | 3.08% | 309,716 | 1,854 | 2.39% |
| Federal funds purchased | 3,676 | 52 | 5.63% | 12,071 | 167 | 5.46% |
| Federal Home Loan Bank advances | 28,473 | 379 | 5.26% | 30,176 | 395 | 5.17% |
| Company-obligated mandatorily redeemable capital securities | 4,124 | 71 | 6.84% | 4,124 | 87 | 8.35% |
| Total interest-bearing liabilities | 367,484 | 3,045 | 3.32% | 356,087 | 2,503 | 2.80% |
| Other liabilities | 3,489 | | | | | |
| Shareholders' equity | 40,553 | | | | | |
| Total Liabilities & Shareholders' Equity | \$ 488,629 | | | \$ 446,372 | | |
| Net interest spread | | \$ 4,758 | 3.49% | | \$ 4,953 | 3.75% |
| Interest expense as a percent of average earning assets | | | 2.68% | | | 2.21% |
| Net interest margin | | | 4.12% | | | 4.34% |

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

RATE/VOLUME ANALYSIS

The following table sets forth certain information regarding changes in interest income and interest expense of the Company for the three-month periods ended June 30, 2007 and 2006. 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 the prior period rate); and changes in rate (change in rate multiplied by the prior period volume). Changes which cannot be separately identified are allocated proportionately between changes in volume and changes in rate.

RATE / VOLUME VARIANCE
(In Thousands)

| | Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006 | | |
|---|---|------------------|----------------|
| | Change | Due to Volume | Due to Rate |
| INTEREST INCOME | | | |
| Loans; taxable | \$ 336 | \$ 136 | \$ 200 |
| Loans; tax-exempt (1) | (11) | (12) | 1 |
| Securities; taxable | (14) | (54) | 40 |
| Securities; tax-exempt (1) | 5 | 5 | |
| Deposits in banks | 10 | 5 | 5 |
| Federal funds sold | 21 | 10 | 11 |
| | | | |
| Total Interest Income | 347 | 90 | 257 |
| | | | |
| INTEREST EXPENSE | | | |
| NOW accounts | 144 | 7 | 137 |
| Money market accounts | (41) | (43) | 2 |
| Premium money market accounts | 235 | 189 | 46 |
| Savings accounts | 1 | (5) | 6 |
| Time deposits | 350 | 137 | 213 |
| Federal funds purchased | (115) | (116) | 1 |
| Federal Home Loan Bank advances | (16) | (22) | 6 |
| Company-obligated mandatorily redeemable capital securities | (16) | | (16) |
| | | | |
| Total Interest Expense | 542 | 147 | 395 |
| | | | |
| Net Interest Income | \$ (195) | \$ (57) | \$ (138) |

(1) Income and rates on non-taxable assets are computed on a

tax equivalent
basis using a
federal tax rate
of 34%.

The monitoring and management of net interest income is the responsibility of the Bank's Asset and Liability Management Committee (ALCO). ALCO meets no less than once a month, and is comprised of the Bank's senior management.

PROVISION FOR LOAN LOSSES. The provision for loan losses was \$120,000 and \$180,000, respectively, for the three months ended June 30, 2007 and 2006. The respective amounts of the provision for loan losses were determined 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 nonperforming loans, estimated values of collateral, and the impact of economic conditions on borrowers. There can be no assurances, however, that future losses will not exceed estimated amounts, or that additional provisions for loan losses will not be required in future periods. Please refer to the section entitled "Critical Accounting Policies: Allowance for Loan Losses" above for an explanation of the allowance methodology.

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TOTAL OTHER INCOME. Total other income increased by \$80,000 or 5.6% from \$1.43 million for the three months ended June 30, 2006 to \$1.51 million for the three months ended June 30, 2007 primarily due to increased income from VISA check card fees and WMS fees. Wealth management income increased \$18,000 or 5.5% to \$355,000 for the June 2007 quarter compared with \$336,000 for the same quarter one year earlier. Management seeks to increase the level of its future fee income from WMS through the increase of its market share within the Company's marketplace. WMS fees are projected to show moderate growth during the remainder of 2007 and through 2008. Service charges on deposit accounts decreased \$6,000 or 0.8% to \$718,000 for the quarter ended June 30, 2007, compared with \$724,000 for the same quarter one year earlier. Income on other service charges, commission and fees increased \$68,000 or 18.2% to \$441,000 for the quarter ended June 30, 2007 compared with \$373,000 one year earlier primarily due to increased income from VISA check card fees.

TOTAL OTHER EXPENSES. Total other expenses decreased 1.2% or \$50,000 to \$4.27 million for the three months ended June 30, 2007, compared with \$4.32 million for the three months ended June 30, 2006. Salary and benefits expenses decreased \$8,000, or 0.3% from the June 2006 quarter to the June 2007 quarter. A decrease in retirement plan expenses and payroll taxes was mostly offset by annual salary and promotion increases. Net occupancy expenses increased \$3,000 or 1.0% from the June 2006 quarter to the June 2007 quarter. Furniture and equipment expenses decreased \$52,000 or 14.9% over the same time period, primarily reflecting the decrease in computer hardware and software depreciation. Consulting expense, which includes legal and audit fees, decreased \$39,000 or 16.9% due to reduced audit fees, as well as reduced consulting expense for board governance and strategic planning. Data processing expense increased \$31,000 or 11.0% reflecting the increase in the number of the Bank's customers who use internet banking. Other operating expenses increased \$20,000 or 2.8%, primarily reflecting increases in courier expenses.

Management expects the costs associated with Sarbanes-Oxley compliance to increase during the remainder of 2007 in connection with implementing the requirements of Section 404 regarding Management's Report on Internal Controls. The aggregate market value of the Company's common stock held by non-affiliates reached approximately \$76.6 million as of June 30, 2007, and therefore, the Company will be required to comply with Section 404 for the year ending December 31, 2007.

The Bank expects 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 provide. The Bank projects to increase staff from its June 30, 2007 level of 148 full-time equivalent personnel by approximately one additional full-time equivalent person during the remainder of 2007 at an approximate additional salary and benefits cost of \$20,000.

COMPARISON OF OPERATING RESULTS FOR THE SIX MONTHS ENDED JUNE 30, 2007 AND JUNE 30, 2006

NET INCOME. Net income for the six months ended June 30, 2007 was \$2.45 million or \$0.69 per diluted share compared with \$2.69 million or \$0.75 per diluted share for the six months ended June 30, 2006. The decline in net income of 8.7% for the first six months of 2007 versus the same period of 2006 was due primarily to the inclusion of a \$250,000 pre-tax gain in the first quarter of 2006 resulting from the cancellation of a property usage contract. In addition, there was a \$365,000 decrease in net interest income in the first six months of 2007 versus the same period of 2006.

NET INTEREST INCOME. Net interest income decreased \$365,000 or 3.8% to \$9.28 million for the six months ended June 30, 2007 compared with \$9.64 million for the six months ended June 30, 2006. The decrease in net interest income resulted from the decrease in the net interest margin. Computed on a tax equivalent basis, the net interest margin for the six months ended June 2007 was 4.04%, compared with 4.35% for the same period one year earlier. The primary reasons for the decrease in the net interest margin are the impact of the inversion of yield curve from July 2006 through June 2007, coupled with competitive pressures on the pricing of interest-earning assets and interest-bearing liabilities. In an inverted yield curve, the interest rates on shorter-term debt instruments exceed the interest rates on longer-term debt instruments. The impact of the declining net interest margin was partially offset by a 3.4% increase in total average earning assets from \$445.1 million during the first six months of 2006 to \$460.0 million

for the first six months of 2007.

The yield on average interest-earning assets was 6.76% for the six months ended June 30, 2007 compared with 6.46% for the six months ended June 30, 2006. Total interest income increased \$1.19 million or 8.1% to \$15.51 million for the six months ended June 30, 2007, compared with \$14.32 million for the six months ended June 30, 2006, as a result of the growth in the volume of interest-earning assets and in the average rate of interest earned. Interest and dividends on investment securities decreased \$53,000 or 5.5%. Investment securities averaged \$38.8 million for the first six months of 2007 compared with \$45.1 million for the same period one year earlier. The yield on investment securities was 4.76% on a tax equivalent basis for the first six months of 2007, compared with 4.33% for the first six months of 2006. Interest and fees on loans increased \$1.18 million or 8.9% to \$14.51 million for the six months ended June 30, 2007 compared with the same period one year earlier. Average loans outstanding totaled \$417.2 million and earned 6.97% on a tax equivalent basis for the six months ended June 30, 2007, compared with \$398.5 million and 6.71%, respectively, for the six months ended June 30, 2006.

Total interest expense increased \$1.55 million or 33.2% to \$6.23 million for the six months ended June 30, 2007 from \$4.68 million for the six months ended June 30, 2006. Average interest-bearing liabilities grew 6.3% to \$374.4 million for the first six months of 2007 compared with \$352.1 million for the first six months of 2006, while the average cost of interest-bearing liabilities increased to 3.35% from 2.67% for the same respective time periods. The increase in total interest expense and the average cost of interest-bearing liabilities is primarily due to the overall increase in short-term interest rates, as well as significantly increased balances in higher cost funding sources such as the premium interest rate money market account, time deposits, and subsidiary trust capital. The average balance for the premium interest rate money market account was \$64.1 million with an average cost of 4.09% for the six months ended June 30, 2007 compared with \$45.6 million with an average cost of 3.89% for the six months ended June 30, 2006. Average time deposit balances for the first six months of 2007 were \$131.9 million at an average cost of 4.54%, compared with \$110.3 million at an average cost of 3.68% for the same period one year earlier. Interest-bearing NOW account deposits averaged \$71.4 million at an average cost of 1.21% for the six months ended June 30, 2007 quarter, compared with \$70.4 million at an average cost of 0.55% for the six months ended June 30, 2006. Other interest-bearing money market deposits averaged \$27.3 million at an average cost of 1.43% for the six months ended June 30, 2007, compared with \$39.8 million at an average cost of 1.38% for the same period one year earlier. Savings account deposits averaged \$33.7 million at an average cost of 0.41% for the first six months of 2007, compared with \$38.3 million at an average cost of 0.33% for the first six months of 2006. Average FHLB of Atlanta advances were \$34.9 million at an average cost of 5.16% for the first half of 2007, and \$35.8 million at an average cost of 4.90% for the same period one year earlier. Capital securities of the subsidiary trust averaged \$6.1 million at an average cost of 7.38% for the six months ended June 30, 2007, compared with \$4.1 million at an average cost of 8.33% for the six months ended June 30, 2006.

The following table sets forth information relating to the Company's average balance sheet and reflects the average yield on assets and the average annualized cost of liabilities for the six-month periods ended June 30, 2007 and 2006. These yields and costs are derived by annualizing the income or expense for the periods presented, and dividing the product of the annualization by the respective average daily balances of assets and liabilities for the periods presented.

AVERAGE BALANCES, INCOME AND EXPENSES, AND AVERAGE YIELDS AND RATES
(In Thousands)

| | Six Months Ended June 30, 2007 | | | Six Months Ended June 30, 2006 | | |
|---|--------------------------------|--------------------|-----------------|--------------------------------|--------------------|-----------------|
| | Average Balances | Income/ Expense | Average Rate | Average Balances | Income/ Expense | Average Rate |
| ASSETS: | | | | | | |
| Loans | | | | | | |
| Taxable | 407,805 | 14,327 | 7.00% | 389,581 | 13,130 | 6.71% |
| Tax-exempt (1) | 7,779 | 281 | 7.18% | 8,030 | 301 | 7.45% |
| Nonaccrual | 1,601 | | | 918 | | |
| Total Loans | 417,185 | 14,607 | 6.97% | 398,529 | 13,431 | 6.71% |
| Securities | | | | | | |
| Taxable | 37,604 | 879 | 4.67% | 44,046 | 935 | 4.25% |
| Tax-exempt (1) | 1,150 | 45 | 7.77% | 1,018 | 40 | 7.81% |
| Total securities | 38,754 | 924 | 4.76% | 45,064 | 975 | 4.33% |
| Deposits in banks | | | | | | |
| Federal funds sold | 1,472 | 21 | 2.79% | 678 | 11 | 3.31% |
| | 2,595 | 67 | 5.10% | 785 | 17 | 4.41% |
| Total earning assets | 460,006 | 15,618 | 6.76% | 445,056 | 14,435 | 6.46% |
| Less: Reserve for loan losses | (4,500) | | | (4,336) | | |
| Cash and due from banks | 15,100 | | | 17,280 | | |
| Bank premises and equipment, net | 7,499 | | | 8,198 | | |
| Other assets | 15,678 | | | 18,082 | | |
| Total Assets | 493,783 | | | 484,280 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY: | | | | | | |
| Deposits | | | | | | |
| Demand deposits | 75,713 | | | 89,586 | | |
| Interest-bearing deposits | | | | | | |
| NOW accounts | 71,415 | 430 | 1.21% | 70,449 | 190 | 0.55% |
| Money market accounts | 27,347 | 194 | 1.43% | 39,795 | 272 | 1.38% |
| Premium money market accounts | 64,088 | 1,300 | 4.09% | 45,569 | 879 | 3.89% |
| Savings accounts | 33,747 | 68 | 0.41% | 38,330 | 63 | 0.33% |
| Time deposits | 131,892 | 2,969 | 4.54% | 110,275 | 2,013 | 3.68% |

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| | | | | | | |
|---|---------|-------|-------|---------|-------|-------|
| Total interest-bearing deposits | 328,489 | 4,961 | 3.05% | 304,418 | 3,417 | 2.27% |
| Federal funds purchased | 4,969 | 138 | 5.62% | 7,769 | 204 | 5.31% |
| Federal Home Loan Bank advances | 34,862 | 904 | 5.16% | 35,785 | 882 | 4.90% |
| Company-obligated mandatorily redeemable capital securities | 6,129 | 227 | 7.38% | 4,124 | 173 | 8.33% |
| | | | | | | |
| Total interest-bearing liabilities | 374,449 | 6,230 | 3.35% | 352,096 | 4,676 | 2.67% |
| Other liabilities | 3,548 | | | 2,636 | | |
| Shareholders equity | 40,072 | | | 36,962 | | |
| | | | | | | |
| Total Liabilities & Shareholders Equity | 493,783 | | | 481,280 | | |
| | | | | | | |
| Net interest spread | | 9,388 | 3.41% | | 9,759 | 3.79% |
| | | | | | | |
| Interest expense as a percent of average earning assets | | | 2.72% | | | 2.11% |
| Net interest margin | | | 4.04% | | | 4.35% |

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

RATE/VOLUME ANALYSIS

The following table sets forth certain information regarding changes in interest income and interest expense of the Company for the six-month periods ended June 30, 2007 and 2006. 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 the prior period rate); and changes in rate (change in rate multiplied by the prior period volume). Changes which cannot be separately identified are allocated proportionately between changes in volume and changes in rate.

RATE / VOLUME VARIANCE
(In Thousands)

| | Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006 | | |
|---|---|------------------|----------------|
| | Change | Due to Volume | Due to Rate |
| INTEREST INCOME | | | |
| Loans; taxable | \$ 1,196 | \$ 608 | \$ 588 |
| Loans; tax-exempt (1) | (20) | (9) | (11) |
| Securities; taxable | (56) | (127) | 71 |
| Securities; tax-exempt (1) | 5 | 5 | |
| Deposits in banks | 9 | 13 | (4) |
| Federal funds sold | 49 | 40 | 9 |
| | | | |
| Total Interest Income | 1,183 | 530 | 653 |
| | | | |
| INTEREST EXPENSE | | | |
| NOW accounts | 239 | 3 | 236 |
| Money market accounts | (78) | (85) | 7 |
| Premium money market accounts | 422 | 357 | 65 |
| Savings accounts | 5 | (8) | 13 |
| Time deposits | 956 | 395 | 561 |
| Federal funds purchased | (66) | (74) | 8 |
| Federal Home Loan Bank advances | 21 | (23) | 44 |
| Company-obligated mandatorily redeemable capital securities | 55 | 84 | (29) |
| | | | |
| Total Interest Expense | 1,554 | 649 | 905 |
| | | | |
| Net Interest Income | \$ (371) | \$ (119) | \$ (252) |

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

The monitoring and management of net interest income is the responsibility of the Bank's Asset and Liability Management Committee (ALCO). ALCO meets no less than once a month, and is comprised of the Bank's senior management.

PROVISION FOR LOAN LOSSES. The provision for loan losses was \$240,000 and \$300,000, respectively, for the six months ended June 30, 2007 and 2006.

TOTAL OTHER INCOME. Total other income increased by \$20,000 or 0.7% from \$2.92 million for the six months ended June 30, 2006 to \$2.94 million for the six months ended June 30, 2007. Wealth management income increased \$30,000 or 4.5% to \$694,000 for the first six months of 2007 compared with \$664,000 for the same period one year earlier. Service charges on deposit accounts increased \$18,000, or 1.3% to \$1.38 million for the six months ended June 30, 2007, compared with \$1.36 million for the same period one year earlier. Income on other service charges, commission and fees increased \$140,000 or 19.2% to \$865,000 for the six months ended June 30, 2007 compared with \$725,000 one year earlier primarily due to income from its ownership interest in Bankers Insurance, as well as increased income from VISA check card fees. During the first quarter of 2006, the Bank entered into an agreement cancelling a property usage contract, as mentioned above, for which the Bank received a one-time payment of \$250,000, or approximately \$165,000 net of applicable income taxes. Additionally, during the first quarter of 2006, the Bank sold \$2.95 million of lower yielding investment securities at a loss of \$83,000 and utilized the proceeds from the sale to retire high cost borrowed funds.

TOTAL OTHER EXPENSES. Total other expenses increased 0.4% or \$34,000 to \$8.45 million for the six months ended June 30, 2007, compared with \$8.42 million for the six months ended June 30, 2006. Salary and benefits expenses increased \$157,000 or 3.5% from the first six months of 2006 to the first six months of 2007. Annual salary and promotion increases were the primary cause for the growth in salary and benefits expenses. Net occupancy expenses increased \$29,000 or 5.9% from the first half of 2006 to the first half of 2007 primarily reflecting increases in snow and ice removal. Furniture and equipment expenses decreased \$96,000 or 14.1% over the same time period, primarily reflecting the decrease in computer hardware and software depreciation. Advertising expense increased \$17,000 or 6.5%. Consulting expense, which includes legal and audit fees, decreased \$93,000 or 17.7% due to reduced audit fees, as well as reduced consulting expense for board governance and strategic planning. Data processing expense increased \$59,000 or 10.7% reflecting the increase in the number of the Bank's customers who use internet banking. Other operating expenses decreased \$39,000 or 2.8%, primarily reflecting decreases in loan production expenses.

COMPARISON OF JUNE 30, 2007 AND DECEMBER 31, 2006 FINANCIAL CONDITION

Assets totaled \$486.0 million at June 30, 2007, a decrease of 6.9% or \$35.8 million from \$521.8 million at December 31, 2006. Balance sheet categories reflecting significant changes include cash and due from banks, loans, deposits, FHLB of Atlanta advances, and company-obligated mandatorily redeemable capital securities. Each of these categories is discussed below.

CASH AND DUE FROM BANKS. Cash and due from banks was \$13.4 million and \$21.0 million at June 30, 2007 and December 31, 2006, respectively. The decrease in cash and due from banks at June 30, 2007 is the result of timing differences of the Bank's deposits with the Federal Reserve Bank of Richmond in order to satisfy reserve requirements.

LOANS. Net loans were \$405.2 million at June 30, 2007, which is a decrease of \$10.9 million or 2.6% from \$416.1 million at December 31, 2006. The decline in total loans is primarily attributable to the decreases of \$7.8 million in commercial real estate loans, \$3.7 million in consumer loans, and \$1.6 million in commercial and industrial loans, partially offset by an increase of \$2.9 million in 1-to-4 family residential loans. The Bank's loans are made primarily to customers located within the Bank's primary market area.

DEPOSITS. At June 30, 2007, total deposits were \$410.2 million, reflecting a decrease of \$5.9 million or 1.4% from \$416.1 million at December 31, 2006. The decline was attributable to a decline in noninterest-bearing deposits of \$7.5 million, partially offset by a \$1.6 million increase in interest-bearing deposits. During the first half of 2007, the Bank decreased its usage of brokered deposits by \$13.0 million from \$20.2 million at December 31, 2006 to \$7.2 million at June 30, 2007. The Bank expects to increase its deposits during the remainder of 2007 and beyond through the offering of a wide array of value-added checking products, and selective rate premiums on interest-bearing time deposits.

FEDERAL HOME LOAN ADVANCES. FHLB of Atlanta advances were \$28.0 million at June 30, 2007, compared with \$55.0 million at December 31, 2006. The \$27.0 million decrease in FHLB of Atlanta advances reflects the decline in profitable loan and investment opportunities and daily cash requirements.

COMPANY-OBLIGATED MANDATORILY REDEEMABLE CAPITAL SECURITIES OF SUBSIDIARY TRUST (capital securities). Capital securities declined by \$4.1 million from \$8.2 million on December 31, 2006 to \$4.1 million on June 30, 2007.

On March 26, 2002, the Company established a subsidiary trust that issued \$4.0 million of capital securities as part of a pooled trust preferred security offering with other financial institutions. 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.

On September 21, 2006, the Company's second subsidiary trust privately issued \$4.0 million face amount of the trust's Floating Rate Capital Securities in a pooled trust preferred security offering. 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. The purpose of the September 2006 issuance was to use the proceeds to redeem on March 26, 2007 the existing capital securities issued on March 26, 2002. Because of changes in the market pricing of capital securities from 2002 to 2006, the September 2006 issuance is priced 190 basis points less than that of the March 2002 issuance, and the repayment of the March 2002 issuance on March 26, 2007 reduced the interest expense associated with the distribution on capital securities of subsidiary trust by \$76,000 annually.

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ASSET QUALITY

Nonperforming assets, in most cases, consist of loans that are 90 days or more past due and for which the accrual of interest has been discontinued. Management evaluates all loans that are 90 days or more past due, as well as loans that have suffered financial distress, to determine if they should be placed on non-accrual status. Factors considered by management include the estimated value of collateral, if any, and other resources of the borrower that may be available to satisfy the delinquency. Nonperforming assets totaled \$1.01 million or 0.25% of total loans at June 30, 2007, as compared with \$1.75 million or 0.42% of total loans at December 31, 2006, and \$1.76 million or 0.42% of total loans at June 30, 2006.

The provision for loan losses was \$240,000 for the first six months of 2007 compared with \$300,000 for the first six months of 2006.

Loans that are 90 days past due and accruing interest totaled \$1,000 at June 30, 2007 and December 31, 2006, respectively. No loss is anticipated on these loans based on the value of the underlying collateral and other factors. There are no loans, other than those disclosed above as either nonperforming or impaired, where known information about the borrower has caused management to have serious doubts about the borrower's ability to repay the loan. There are also no other interest-bearing assets that would be subject to disclosure as either nonperforming or impaired if such interest-bearing assets were loans. The largest concentration of loans to borrowers engaged in similar activities at June 30, 2007 was \$20.5 million for hotel/motel/inn loans, which represents 5.0% of total loans. No other concentration exceeded \$12.4 million or approximately 3.0% of total loans.

CONTRACTUAL OBLIGATIONS

As of June 30, 2007, there have been no 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, 2006.

OFF-BALANCE SHEET ARRANGEMENTS

As of June 30, 2007, there have been no material changes to the off-balance sheet arrangements disclosed in Management's Discussion and Analysis in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

CAPITAL RESOURCES

Total shareholders' equity was \$40.2 million at June 30, 2007 compared to \$38.7 million at December 31, 2006, an increase of \$1.5 million, or 3.9%. Retained earnings increased by \$1.3 million or 4.6% from December 31, 2006 to June 30, 2007. The change in the accumulated other comprehensive loss component of shareholders' equity from December 31, 2006 to June 30, 2007 reduced shareholders' equity by \$14,000. Included in the accumulated other comprehensive loss component of shareholders' equity for both December 31, 2006 and June 30, 2007 is the implementation of SFAS No. 158 regarding the Bank's defined benefit retirement plan, which increased the loss by \$671,000 net of tax benefit at both dates.

The Company repurchased 8,270 shares of its common stock during the first six months of 2007 at an average price of \$24.98 per share for a total cost of \$207,000. The Company's newly issued 63,650 shares of common stock at an average price of \$8.50 in connection with stock option exercises under the Company's stock option plans during the first six months of 2007 added a total of \$541,000 to shareholders' equity.

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).

Under these guidelines, the \$4.0 million at June 30, 2007 and \$8.0 million at December 31, 2006 of capital securities issued by the Company's subsidiary trusts are treated as Tier 1 capital for purposes of the Federal Reserve's capital guidelines for bank holding companies, because the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital. At both June 30, 2007 and December 31, 2006, the Company and the Bank exceed their minimum regulatory capital ratios. The following table sets forth the regulatory capital ratio calculations for the Company:

REGULATORY CAPITAL RATIOS
(In Thousands)

| | June 30, 2007 | December 31, 2006 |
|---|-------------------|----------------------|
| Tier 1 Capital: | | |
| Shareholders' Equity | \$ 40,230 | \$ 38,712 |
| Plus: Unrealized loss on securities available for sale | 360 | 365 |
| Plus: Unrealized loss on defined benefit plan under SFAS 158 | 671 | 671 |
| Less: Intangible assets, net | | (6) |
| Plus: Company-obligated mandatorily redeemable capital securities | 4,000 | 8,000 |
| Total Tier 1 Capital | 45,261 | 47,742 |
| Tier 2 Capital: | | |
| Allowable Allowance for Loan Losses | 4,407 | 4,471 |
| Total Capital | \$ 49,668 | \$ 52,213 |
| Risk Weighted Assets: | \$ 386,419 | \$ 404,603 |
| Regulatory Capital Ratios: | | |
| Leverage Ratio | 9.26% | 9.50% |
| Tier 1 to Risk Weighted Assets | 11.71% | 11.80% |
| Total Capital to Risk Weighted Assets | 12.85% | 12.90% |

LIQUIDITY

The primary sources of funds are deposits, repayment of loans, maturities of investments, funds provided from operations, and advances from the FHLB of Atlanta. While scheduled repayments of loans and maturities of investment securities are predictable sources of funds, deposit flows and loan repayments are greatly influenced by the general level of interest rates, economic conditions and competition. The Bank uses its sources of funds to fund existing and future loan commitments, to fund maturing certificates of deposit and demand deposit withdrawals, to invest in other interest-earning assets, to maintain liquidity, and to meet operating expenses. Management monitors projected liquidity needs and determines the desirable funding level based in part on the Bank's commitments to make loans and management's assessment of the Bank's ability to generate funds. Cash and amounts due from depository institutions, interest-earning deposits in other banks, and federal funds sold totaled \$19.1 million at June 30, 2007 compared with \$41.7 million at December 31, 2006. These assets provide the primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available for sale, of which approximately \$20.3 million is unpledged and readily salable. Furthermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately \$136.9 million at June 30, 2007 to provide additional sources of liquidity, as well as federal funds borrowing lines of credit with the Federal Reserve and various commercial banks totaling approximately \$52.2 million. At June 30, 2007, \$28.0 million of the FHLB of Atlanta line of credit and none

of the federal funds borrowing lines of credit were in use. Capital expenditures for the building of the Haymarket branch are estimated to be \$1.6 million to be paid over an estimated nine month period beginning in the fourth quarter of 2007.

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The following table sets forth information relating to the Company's sources of liquidity and the outstanding commitments for use of liquidity at June 30, 2007 and December 31, 2006. 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
(In Thousands)

| | June 30, 2007 | | | December 31, 2006 | | |
|--|-------------------|------------------|-------------------|-------------------|------------------|-------------------|
| | Total | In Use | Available | Total | In Use | Available |
| Sources: | | | | | | |
| Federal funds borrowing lines of credit | \$ 52,152 | \$ | \$ 52,152 | \$ 51,901 | \$ | \$ 51,901 |
| Federal Home Loan Bank advances | 136,944 | 28,000 | 108,944 | 139,194 | 55,000 | 84,194 |
| Federal funds sold | | | 5,244 | | | 20,122 |
| Securities, available for sale and unpledged at fair value | | | 20,279 | | | 21,070 |
| Total short-term funding sources | \$ 189,096 | \$ 28,000 | \$ 186,619 | \$ 191,095 | \$ 55,000 | \$ 177,287 |
| Uses: | | | | | | |
| Unfunded loan commitments and lending lines of credit | | | \$ 58,080 | | | \$ 50,801 |
| Letters of credit | | | 7,955 | | | 8,679 |
| Total potential short-term funding uses | | | \$ 66,035 | | | \$ 59,480 |
| Ratio of short-term funding sources to potential short-term funding uses | | | 282.6% | | | 298.1% |

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 advances from the FHLB of Atlanta and federal funds borrowing lines of credit.

IMPACT OF INFLATION AND CHANGING PRICES

The consolidated financial statements and the accompanying notes presented elsewhere in this report have been prepared in accordance with GAAP, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of the Company and the Bank are monetary in nature. The impact of inflation is reflected in the increased cost of operations. As a result, interest

rates have a greater impact on our performance than inflation does. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Company does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

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In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity must report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company is in the process of evaluating the impact SFAS 159 may have on its consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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, 2006.

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains a system of disclosure controls and procedures that is designed to ensure that material information is accumulated and communicated to management, including the Company's chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure. As required, management, with the participation of the Company's chief executive officer and chief financial officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures were operating effectively to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized, and reported within the time periods specified in the Commission's rules and forms.

Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that the Company's disclosure controls and procedures will detect or uncover every situation involving the failure of persons within the Company or its subsidiary to disclose material information required to be set forth in the Company's periodic reports.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. There were no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company'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 that, in the opinion of management, may materially impact the financial condition of either company.

ITEM 1A. RISK FACTORS

There have been no material changes in the risk factors faced by the Company from those disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
 Issuer Purchases of Equity Securities

| | | | Total Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Number of Shares that May Yet Be Purchased Under the Plan |
|------------------|---|---|--|--|
| | Total Number of Shares Purchased | Average Price Paid per Share | (1) | (1) |
| April 1 30, 2007 | 1,360 | \$ 25.61 | 1,360 | 204,943 |
| May 1 31, 2007 | 2,400 | \$ 24.60 | 2,400 | 202,543 |
| June 1 30, 2007 | 2,075 | \$ 24.40 | 2,075 | 200,468 |
| Total | 5,835 | | 5,835 | |

(1) In September 1998, the Company announced a stock repurchase program for its common stock. Initially, the plan authorized the Company to repurchase up to 73,672 shares of its common stock through December 31, 1999. Annually, the Board resets the amount of shares authorized to be repurchased during the year under the buyback program. On January 18, 2007, the Board authorized the Company to repurchase up to

208,738 shares
 (6% of the shares
 of common stock
 outstanding on
 January 1, 2007)
 beginning
 January 1, 2007
 and continuing
 until the next
 Board reset.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

The Company held its Annual Meeting of Shareholders on May 15, 2007. A quorum of Shareholders was present, consisting of a total of 2,827,356.72 shares, with 2,797,500.72 shares represented by proxy. At the Annual Meeting, the Shareholders elected Class II directors Randy K. Ferrell, Brian S. Montgomery, P. Kurt Rodgers and Sterling T. Strange, III to three-year terms. The following Class I and Class III directors whose terms expire in 2008 and 2009 continued in office: John B. Adams, Jr., Douglas C. Larson, C. H. Lawrence, Jr., Randolph T. Minter, John J. Norman, Jr. and H. Frances Stringfellow. The Shareholders also ratified the selection of Smith Elliott Kearns & Company, LLC as independent auditors of the Company for the year ending December 31, 2007.

The vote on each matter was as follows:

1. For Directors:

| | FOR | WITHHELD |
|--------------------------|--------------|----------|
| Randy K. Ferrell | 2,822,885.72 | 4,471.00 |
| Brian S. Montgomery | 2,823,034.33 | 4,322.39 |
| P. Kurt Rodgers | 2,820,104.72 | 7,252.00 |
| Sterling T. Strange, III | 2,819,604.72 | 7,752.00 |

2. Ratification of the selection of Smith Elliott Kearns & Company, LLC as the independent auditors for the Company and the Bank:

| FOR | AGAINST | ABSTAIN | BROKER NON-VOTE |
|--------------|-----------|-----------|-----------------|
| 2,797,500.72 | 16,392.00 | 13,464.00 | 0.00 |

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

- 3.1 Articles of Incorporation of Fauquier Bankshares, Inc., as amended, incorporated by reference to Exhibit 3(i) to registration statement on Form 10 filed April 16, 1999
- 3.2 Amended and Restated Bylaws of Fauquier Bankshares, Inc., incorporated by reference to Exhibit 3.2 to Form 8-K filed March 22, 2006
- 10.20 Consulting Agreement, dated April 19, 2007 between The Fauquier Bank and C.H. Lawrence, Jr., incorporated by reference to Exhibit 10.20 to Form 10-Q filed May 14, 2007
- 10.21 Employment Agreement, dated April 2, 2007, between Fauquier Bankshares, Inc., The Fauquier Bank and Gregory D. Frederick, incorporated by reference to Exhibit 10.21 to Form 8-K/A filed April 4, 2007
- 11 Refer to Part I, Item 1, Note 5 to the Consolidated Financial Statements
- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)
- 32.1 Certification Pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer
- 32.2 Certification Pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer

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 and Chief Executive Officer
(principal executive officer)
Dated: August 10, 2007

/s/ Eric P. Graap
Eric P. Graap
Executive Vice President and Chief
Financial Officer (principal financial and
accounting officer)
Dated: August 10, 2007