FAUQUIER BANKSHARES, INC.
Form 10-Q
November 07, 2008

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

(Mark One)

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended September 30, 2008**

**or**

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the transition period from __________to__________**

**Commission File No.: 000-25805**
**Fauquier Bankshares, Inc.**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Virginia** | **54-1288193** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **10 Courthouse Square, Warrenton, Virginia** | **20186** |
| (Address of principal executive offices) | (Zip Code) |

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer þ | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.) Yes o No þ

The registrant had 3,564,317 shares of common stock outstanding as of November 5, 2008.

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

ITEM 1. FINANCIAL STATEMENTS

**Fauquier Bankshares, Inc. and Subsidiaries**
**Consolidated Balance Sheets**

| | September 30, 2008 (Unaudited) | December 31, 2007 (Audited)* |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 13,652,340 | $ 16,708,922 |
| Interest-bearing deposits in other banks | 1,267,882 | 823,252 |
| Federal funds sold | | 2,020,000 |
| Securities available for sale | 35,284,228 | 37,376,725 |
| Loans, net of allowance for loan losses of $4,684,438 in 2008 and $4,185,209 in 2007 | 423,077,211 | 409,107,482 |
| Bank premises and equipment, net | 8,331,851 | 7,180,369 |
| Accrued interest receivable | 1,681,120 | 1,748,546 |
| Other assets | 16,465,251 | 14,930,932 |
| Total assets | $ 499,759,883 | $ 489,896,228 |
| **Liabilities and Shareholders Equity** | | |
| Deposits: | | |
| Noninterest-bearing | 65,139,676 | 76,080,935 |
| Interest-bearing: | | |
| NOW accounts | 77,441,602 | 90,169,640 |
| Savings and money market accounts | 115,406,759 | 127,472,913 |
| Time certificates of deposit | 147,635,155 | 110,835,435 |
| Total interest-bearing | 340,483,516 | 328,477,988 |
| Total deposits | 405,623,192 | 404,558,923 |
| Federal Home Loan Bank advances | 45,000,000 | 35,000,000 |
| Company-obligated mandatorily redeemable capital securities | 4,124,000 | 4,124,000 |
| Other liabilities | 4,421,845 | 4,385,553 |
| Commitments and Contingencies | | |
| Total liabilities | 459,169,037 | 448,068,476 |
| **Shareholders Equity** | | |
| Common stock, par value, $3.13; authorized 8,000,000 shares: issued and outstanding, 2008: 3,566,286 (includes nonvested shares of 38,219); 2007: 3,537,354 shares (includes nonvested shares of 31,190) | 11,042,850 | 10,974,293 |
| Retained earnings | 32,522,518 | 31,626,627 |
| Accumulated other comprehensive income (loss), net | (2,974,522) | (773,168) |

| | | |
|---|---|---|
| Total shareholders equity | 40,590,846 | 41,827,752 |
| Total liabilities and shareholders equity | $ 499,759,883 | $ 489,896,228 |

* Condensed from audited financial statement.

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**
**Consolidated Statements of Income**
**(Unaudited)**
**For the Three Months Ended September 30, 2008 and 2007**

| | 2008 | 2007 |
|---|---|---|
| **Interest Income** | | |
| Interest and fees on loans | $ 6,701,211 | $ 7,227,839 |
| Interest and dividends on securities available for sale: | | |
| Taxable interest income | 366,630 | 372,966 |
| Interest income exempt from federal income taxes | 58,289 | 37,774 |
| Dividends | 59,978 | 47,046 |
| Interest on federal funds sold | 3 | 15,432 |
| Interest on deposits in other banks | 15,305 | 5,322 |
| Total interest income | 7,201,416 | 7,706,379 |
| **Interest Expense** | | |
| Interest on deposits | 1,761,639 | 2,542,449 |
| Interest on federal funds purchased | 23,877 | 45,709 |
| Interest on Federal Home Loan Bank advances | 519,870 | 436,153 |
| Distribution on capital securities of subsidiary trusts | 45,757 | 72,652 |
| Total interest expense | 2,351,143 | 3,096,963 |
| Net interest income | 4,850,273 | 4,609,416 |
| Provision for loan losses | 431,000 | 120,000 |
| Net interest income after provision for loan losses | 4,419,273 | 4,489,416 |
| **Other Income** | | |
| Wealth management income | 324,890 | 358,441 |
| Service charges on deposit accounts | 763,383 | 762,328 |
| Other service charges, commissions and income | 462,914 | 417,358 |
| (Loss) on impairment of securities | (297,500) | |
| (Loss) on sale of other real estate owned | (3,000) | |
| Total other income | 1,250,687 | 1,538,127 |
| **Other Expenses** | | |
| Salaries and benefits | 2,141,693 | 2,295,427 |
| Net occupancy expense of premises | 328,600 | 265,361 |
| Furniture and equipment | 313,889 | 306,121 |

| | | |
|---|---|---|
| Advertising expense | 142,873 | 139,700 |
| Consulting expense | 261,178 | 226,930 |
| Data processing expense | 325,227 | 343,970 |
| Other operating expenses | 742,605 | 705,891 |
| Total other expenses | 4,256,065 | 4,283,400 |
| Income before income taxes | 1,413,895 | 1,744,143 |
| Income tax expense | 478,892 | 534,006 |
| Net Income | $ 935,003 | $ 1,210,137 |
| **Earnings per Share**, basic | $ 0.26 | $ 0.34 |
| **Earnings per Share**, assuming dilution | $ 0.26 | $ 0.34 |
| **Dividends per Share** | $ 0.20 | $ 0.20 |

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**
**Consolidated Statements of Income**
**(Unaudited)**
**For the Nine Months Ended September 30, 2008 and 2007**

| | 2008 | 2007 |
|---|---|---|
| **Interest Income** | | |
| Interest and fees on loans | $ 20,089,996 | $ 21,739,829 |
| Interest and dividends on securities available for sale: | | |
| Taxable interest income | 1,028,308 | 1,108,418 |
| Interest income exempt from federal income taxes | 174,700 | 67,262 |
| Dividends | 183,098 | 190,450 |
| Interest on federal funds sold | 33,296 | 81,983 |
| Interest on deposits in other banks | 27,851 | 25,984 |
| Total interest income | 21,537,249 | 23,213,926 |
| **Interest Expense** | | |
| Interest on deposits | 5,485,364 | 7,503,724 |
| Interest on federal funds purchased | 87,236 | 184,154 |
| Interest on Federal Home Loan Bank advances | 1,401,345 | 1,339,757 |
| Distribution on capital securities of subsidiary trusts | 155,462 | 300,094 |
| Total interest expense | 7,129,407 | 9,327,729 |
| Net interest income | 14,407,842 | 13,886,197 |
| Provision for loan losses | 1,721,000 | 360,000 |
| Net interest income after provision for loan losses | 12,686,842 | 13,526,197 |
| **Other Income** | | |
| Wealth management income | 1,000,127 | 1,051,999 |
| Service charges on deposit accounts | 2,223,348 | 2,139,644 |
| Other service charges, commissions and income | 1,555,895 | 1,282,355 |
| Gain on sale of other real estate owned | 25,718 | |
| (Loss) on impairment of securities | (422,500) | |
| Realized gain on sale of securities | 87,585 | |
| Total other income | 4,470,173 | 4,473,998 |
| **Other Expenses** | | |
| Salaries and benefits | 6,768,719 | 6,956,868 |
| Net occupancy expense of premises | 958,926 | 798,644 |

| | | |
|---|---|---|
| Furniture and equipment | 885,431 | 889,830 |
| Advertising expense | 468,469 | 421,793 |
| Consulting expense | 802,566 | 660,820 |
| Data processing expense | 987,569 | 956,511 |
| Other operating expenses | 2,175,367 | 2,053,162 |
| Total other expenses | 13,047,047 | 12,737,628 |
| Income before income taxes | 4,109,968 | 5,262,567 |
| Income tax expense | 1,224,045 | 1,600,519 |
| Net Income | $ 2,885,923 | $ 3,662,048 |
| **Earnings per Share**, basic | $ 0.82 | $ 1.05 |
| **Earnings per Share**, assuming dilution | $ 0.81 | $ 1.03 |
| **Dividends per Share** | $ 0.60 | $ 0.59 |

**Fauquier Bankshares, Inc. and Subsidiaries**
**Consolidated Statements of Changes in Shareholders Equity**
**For the Nine Months Ended September 30, 2008 and 2007**

| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Comprehensive Income | Total |
|---|---|---|---|---|---|
| **Balance, December 31, 2006 as restated** | $ 10,789,521 | $ 28,962,409 | $ (1,217,318) | | $ 38,534,612 |
| Comprehensive income: | | | | | |
| Net income | | 3,662,048 | | $ 3,662,048 | 3,662,048 |
| Other comprehensive income net of tax: | | | | | |
| Unrealized holding gains on securities available for sale, net of deferred income taxes of $73,738 | | | 143,138 | 143,138 | 143,138 |
| Total comprehensive income | | | | $ 3,805,186 | |
| Cash dividends ($.59 per share) | | (2,089,302) | | | (2,089,302) |
| Acquisition of 27,370 shares of common stock | (85,668) | (516,802) | | | (602,470) |
| Amortization of unearned compensation, restricted stock awards | | 191,685 | | | 191,685 |
| Issuance of common stock nonvested shares (11,437 shares) | 35,797 | (35,797) | | | |
| Exercise of stock options | 247,664 | 469,410 | | | 717,074 |
| **Balance, September 30, 2007** | $ 10,987,314 | $ 30,643,651 | $ (1,074,180) | | $ 40,556,785 |
| **Balance, December 31, 2007** | $ 10,974,293 | $ 31,626,627 | $ (773,168) | | $ 41,827,752 |
| Comprehensive income: | | | | | |
| Net income | | 2,885,923 | | 2,885,923 | 2,885,923 |
| Other comprehensive income net of tax: | | | | | |
| Unrealized holding losses on securities available for sale, net of tax benefit of $1,145,186 | | | | (2,523,548) | |
| Less: reclassification adjustments, net of taxes of | | | | 322,194 | |

| | | | | | |
|---|---|---|---|---|---|
| $12,721 | | | | | |
| Other comprehensive income net of tax benefit of $1,132,465 | | | (2,201,354) | (2,201,354) | (2,201,354) |
| Total comprehensive income | | | | 684,569 | |
| Effects of changing pension plan measurement date, pursuant to FAS158, net of deferred income tax benefit of $12,437 | | (24,144) | | | (24,144) |
| Initial implementation of EITF 06-4, net of income tax benefit of $6,433 | | (12,487) | | | (12,487) |
| Cash dividends ($.60 per share) | | (2,140,915) | | | (2,140,915) |
| Acquisition of 7,332 shares of common stock | (22,949) | (103,123) | | | (126,072) |
| Amortization of unearned compensation, restricted stock awards | | 244,227 | | | 244,227 |
| Restricted stock forfeiture | | (49,604) | | | (49,604) |
| Issuance of common stock nonvested shares (10,315 shares) | 32,286 | (32,286) | | | |
| Exercise of stock options | 59,220 | 128,300 | | | 187,520 |
| **Balance, September 30, 2008** | $ 11,042,850 | $ 32,522,518 | $ (2,974,522) | | $ 40,590,846 |

See accompanying Notes to Consolidated Financial Statements.

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**Fauquier Bankshares, Inc. and Subsidiaries**
**Consolidated Statements of Cash Flows**
**For the Nine Months Ended September 30, 2008 and 2007**
**(Unaudited)**

| | 2008 | 2007 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | $ 2,885,923 | $ 3,662,048 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 696,976 | 773,598 |
| Provision for loan losses | 1,721,000 | 360,000 |
| Loss on impairment of securities | 422,500 | |
| Gain on sale of securities | (87,585) | |
| Amortization (accretion) of security premiums, net | (7,486) | 3,049 |
| Amortization of unearned compensation, net of forfeiture | 194,623 | 191,685 |
| Changes in assets and liabilities: | | |
| Decrease (increase) in other assets | (315,556) | 60,029 |
| (Decrease) increase in other liabilities | (19,209) | 198,370 |
| Net cash provided by operating activities | 5,491,186 | 5,248,779 |
| **Cash Flows from Investing Activities** | | |
| Proceeds from sale of securities available for sale | 9,078,470 | |
| Proceeds from maturities, calls and principal payments of securities available for sale | 3,710,672 | 2,951,459 |
| Purchase of securities available for sale | (13,965,595) | (3,816,728) |
| Purchase of premises and equipment | (1,848,458) | (462,804) |
| (Purchase) proceeds from sale of other bank stock | (392,300) | 923,500 |
| Net (increase) decrease in loans | (15,690,729) | 9,354,725 |
| Net cash provided by (used in) investing activities | (19,107,940) | 8,950,152 |
| **Cash Flows from Financing Activities** | | |
| Net (decrease) increase in demand deposits, NOW accounts and savings accounts | (35,735,451) | 12,308,976 |
| Net (decrease) increase in certificates of deposit | 36,799,720 | (30,074,213) |
| Federal Home Loan Bank advances | 70,000,000 | 35,000,000 |
| Federal Home Loan Bank principal repayments | (60,000,000) | (55,000,000) |
| Purchase of federal funds | | 4,400,000 |
| Repayment of trust preferred securities | | (4,124,000) |
| Cash dividends paid on common stock | (2,140,915) | (2,089,302) |
| Issuance of common stock | 187,520 | 717,074 |
| Acquisition of common stock | (126,072) | (602,470) |
| Net cash provided by financing activities | 8,984,802 | (39,463,935) |

| | | |
|---|---|---|
| Increase (decrease) in cash and cash equivalents | (4,631,952) | (25,265,004) |
| **Cash and Cash Equivalents** | | |
| Beginning | 19,552,174 | 41,679,655 |
| Ending | $ 14,920,222 | $ 16,414,651 |
| **Supplemental Disclosures of Cash Flow Information** | | |
| Cash payments for: | | |
| Interest | $ 7,262,818 | $ 7,685,021 |
| Income taxes | $ 941,000 | $ 1,363,000 |
| **Supplemental Disclosures of Noncash Investing Activities** | | |
| Unrealized gain (loss) on securities available for sale, net of tax effect | $ (2,523,548) | $ 143,138 |
| FAS 158 Pension Liability Implementation Adjustment, net of tax effect | $ (24,144) | $ |
| Implementation of EITF 06-4, net of tax effect | $ (12,487) | $ |

See accompanying Notes to Consolidated Financial Statements.

**FAUQUIER BANKSHARES, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements**

**Note 1. General**

The consolidated statements include the accounts of Fauquier Bankshares, Inc. ( the Company ) and its wholly-owned subsidiaries: The Fauquier Bank ( the Bank ), Fauquier Statutory Trust I and Fauquier Statutory Trust II; and the Bank s wholly-owned subsidiary, Fauquier Bank Services, Inc. In consolidation, significant intercompany financial balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial positions as of September 30, 2008 and December 31, 2007 and the results of operations for the three and nine months ended September 30, 2008 and 2007. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s 2007 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the results expected for the full year.

**Note 2. Securities**

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|---|---|---|---|---|
| | September 30, 2008 | | | |
| Obligations of U.S. Government corporations and agencies | $ 24,342,106 | $ 134,979 | $ (17,689) | $ 24,459,396 |
| Obligations of states and political subdivisions | 5,294,573 | 28,050 | (185,317) | 5,137,306 |
| Corporate Bonds | 6,000,000 | | (3,789,850) | 2,210,150 |
| Mutual Funds | 300,804 | | (9,648) | 291,156 |
| FHLMC Preferred Bank Stock | 18,500 | | | 18,500 |
| Restricted investments: | | | | |
| Federal Home Loan Bank Stock | 2,905,800 | | | 2,905,800 |
| Federal Reserve Bank Stock | 99,000 | | | 99,000 |
| Community Bankers Bank Stock | 50,000 | | | 50,000 |
| The Bankers Bank Stock | 112,920 | | | 112,920 |
| | $ 39,123,703 | $ 163,029 | $ (4,002,504) | $ 35,284,228 |

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|---|---|---|---|---|
| | December 31, 2007 | | | |
| Obligations of U.S. Government corporations and agencies | $ 23,080,415 | $ 30,014 | $ (162,347) | $ 22,948,082 |
| Obligations of states and political subdivisions | 5,293,965 | 82,166 | (3,948) | 5,372,183 |
| Corporate Bonds | 6,000,000 | | (348,750) | 5,651,250 |
| Mutual Funds | 291,581 | | (5,791) | 285,790 |
| FHLMC Preferred Bank Stock | 441,000 | | (97,000) | 344,000 |
| Restricted investments: | | | | |

| | | | | |
|---|---|---|---|---|
| Federal Home Loan Bank Stock | 2,513,500 | | | 2,513,500 |
| Federal Reserve Bank Stock | 99,000 | | | 99,000 |
| Community Bankers Bank Stock | 50,000 | | | 50,000 |
| The Bankers Bank Stock | 112,920 | | | 112,920 |
| | $ 37,882,381 | $ 112,180 | $ (617,836) | $ 37,376,725 |

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

| | September 30, 2008 | |
|---|---|---|
| | Amortized Cost | Fair Value |
| Due in one year or less | $ 4,106 | 4,103 |
| Due after one year through five years | 1,089,455 | 1,088,003 |
| Due after five years through ten years | 4,670,499 | 4,711,712 |
| Due after ten years | 29,872,619 | 26,003,034 |
| Equity securities | 3,487,024 | 3,477,376 |
| | $ 39,123,703 | $ 35,284,228 |

For the quarter and the nine months ended September 30, 2008, the Bank recognized a permanent impairment of $297,500 and $422,500, respectively on its 10,000 shares of Freddie Mac preferred stock. There were no other impairment losses on securities in the quarter and nine months ended September 30, 2008, or the quarter and nine month period ended September 30, 2007.

For the nine months ended September 30, 2008, gross realized gains from sales of securities available for sale amounted to $87,585. The proceeds from the sale of these securities, including the realized gain, amounted to $9.1 million. The tax expense applicable to this net realized gain amounted to $29,779. There were no securities sold in the quarter ended September 30, 2008 or the quarter and nine month period ended September 30, 2007

The following table shows the Company securities with gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2008 and December 31, 2007.

| September 30, 2008 | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| Description of Securities | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) |
| Obligations of U.S. Government, corporations and agencies | $ 4,784,242 | $ (17,689) | $ | $ | $ 4,784,242 | $ (17,689) |
| Obligations of states and political subdivisions | 4,142,781 | (185,317) | | | 4,142,781 | (185,317) |
| Corporate Bonds | 1,436,040 | (2,563,960) | 774,110 | (1,225,890) | 2,210,150 | (3,789,850) |
| Subtotal, debt securities | 10,363,063 | (2,766,966) | 774,110 | (1,225,890) | 11,137,173 | (3,992,856) |
| Mutual Funds | | | 291,156 | (9,648) | 291,156 | (9,648) |
| FHLMC Preferred Bank Stock | | | | | | |
| Total temporary impaired securities | $ 10,363,063 | $ (2,766,966) | $ 1,065,266 | $ (1,235,538) | $ 11,428,329 | $ (4,002,504) |

| December 31, 2007 | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| Description of Securities | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) |
| Obligations of U.S. Government, corporations | $ | $ | $ 17,798,157 | $ (162,347) | $ 17,798,157 | $ (162,347) |

| | | | | | | |
|---|---|---|---|---|---|---|
| and agencies | | | | | | |
| Obligations of states and political subdivisions | 899,333 | (3,948) | | | 899,333 | (3,948) |
| Corporate Bonds | 3,770,000 | (230,000) | 1,881,250 | (118,750) | 5,651,250 | (348,750) |
| Subtotal, debt securities | 4,669,333 | (233,948) | 19,679,407 | (281,097) | 24,348,740 | (515,045) |
| Mutual Funds | | | 285,790 | (5,791) | 285,790 | (5,791) |
| FHLMC Preferred Bank Stock | 344,000 | (97,000) | | | 344,000 | (97,000) |
| Total temporary impaired securities | $ 5,013,333 | $ (330,948) | $ 19,965,197 | $ (286,888) | $ 24,978,530 | $ (617,836) |

The nature of securities which are temporarily impaired for a continuous 12 month period or more at September 30, 2008 can be segregated into two groups:

The first group consists of two corporate bonds, rated A2 by Moody s, having a total amortized cost of $2.0 million with a temporary loss of approximately $1.2 million. These bonds have an estimated maturity of 26 years, but can be called at par on the five year anniversary, which will occur in 2008 and 2009. If not called, the bonds reprice every three months at a fixed rate index above the three-month London Interbank Offered Rate ( LIBOR ). These bonds are current, they have sufficient cash flow projections to satisfy the cash flow portion of the Other Than Temporary Impairment test under EITF 99-20 as of September 30, 2008, and the Company has the ability to hold these bonds to maturity. Please note that the Bank also has two additional corporate bonds of a similar nature, also rated A2 by Moody s, which have not yet had a continuous impairment of 12 months. These two additional bonds have a total amortized cost of $4.0 million with a temporary loss of approximately $2.6 million. These bonds are also current, they also have sufficient cash flow projections to satisfy the cash flow portion of the Other Than Temporary Impairment test under EITF 99-20 as of September 30, 2008, and the Company has the ability to also hold these bonds to maturity.

The second group consists of a Community Reinvestment Act qualified investment bond fund with a temporary loss of approximately $10,000. The fund is a relatively small segment 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 $26.0 million and $13.6 million at September 30, 2008 and December 31, 2007, respectively.

**Note 3. Loans**

A summary of the balances of loans follows:

| | **September 30, 2008** | **December 31, 2007** |
|---|---|---|
| | (Thousands) | |
| Real estate loans: | | |
| Construction | $ 41,257 | $ 37,204 |
| Secured by farmland | 1,315 | 1,365 |
| Secured by 1 to 4 family residential | 174,053 | 170,983 |
| Other real estate loans | 146,877 | 132,918 |
| Commercial and industrial loans (not secured by real estate) | 36,821 | 38,203 |
| Consumer installment loans | 17,786 | 24,133 |
| All other loans | 10,122 | 8,824 |
| Total loans | $ 428,231 | $ 413,630 |
| Unearned income | (470) | (338) |
| Allowance for loan losses | (4,684) | (4,185) |
| Net loans | $ 423,077 | $ 409,107 |

Of the $146.9 million in other real estate loans, $88.3 million is owner occupied and $58.6 million is non-owner occupied.

**Note 4. Allowance for Loan Losses**

Analysis of the allowance for loan losses follows:

| | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 | Twelve Months Ended December 31, 2007 |
|---|---|---|---|
| Balance at beginning of year | $ 4,185,209 | $ 4,470,533 | $ 4,470,533 |
| Provision for loan losses | 1,721,000 | 360,000 | 717,000 |
| Recoveries of loans previously charged-off | 66,800 | 43,701 | 60,616 |
| Loan losses charged-off | (1,288,571) | (461,038) | (1,062,940) |
| Balance at end of year | $ 4,684,438 | $ 4,413,196 | $ 4,185,209 |

Nonperforming assets consist of the following:

| **(Dollars in thousands)** | September 30, 2008 | December 31, 2007 | September 30, 2007 |
|---|---|---|---|
| Nonaccrual loans | $ 4,457 | $ 1,906 | $ 1,240 |
| Restructured loans | | | |
| Total nonperforming loans | $ 4,457 | $ 1,906 | $ 1,240 |
| Foreclosed property | 133 | 222 | 142 |
| Total nonperforming assets | $ 4,590 | $ 2,128 | $ 1,382 |

| | September 30, 2008 | December 31, 2007 |
|---|---|---|
| Impaired loans for which an allowance has been provided | $ 1,863,300 | $ 2,688,501 |
| Impaired loans for which no allowance has been provided | 3,389,723 | 1,247,461 |
| | $ 5,253,023 | $ 3,935,962 |
| Allowance provided for impaired loans, included in the allowance for loan losses | $ 1,274,158 | $ 1,392,236 |

| | Nine Months Ended | Twelve Months Ended |
|---|---|---|

| | September 30, 2008 | December 31, 2007 |
|---|---|---|
| Average balance in impaired loans | $ 5,201,012 | $ 4,359,817 |
| Interest income recognized on impaired loans | $ 199,884 | $ 261,257 |

Total loans past due 90 days or more and still accruing interest were $1,000 at September 30, 2008 and, $770,000, and $165,000 on December 31, 2007, and September 30, 2007, respectively.

The Company has adopted Financial Accounting Standards Board ( FASB ) Statement No. 114, Accounting by Creditors for Impairment of a Loan, as amended by FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures. FASB Statement No. 114, as amended, requires that the impairment of loans that have been separately identified for evaluation is to be measured based on the present value of expected future cash flows or, alternatively, the observable market price of the loans or the fair value of the collateral. However, for those loans that are collateral dependent (that is, if repayment of those loans is expected to be provided solely by the underlying collateral) and for which management has determined foreclosure is probable, the measure of impairment is to be based on the net realizable value of the collateral. FASB Statement No. 114, as amended, also requires certain disclosures about investments in impaired loans and the allowance for loan losses and interest income recognized on loans.

A loan is considered impaired when it is probable that the Bank will be unable to collect all principal and interest amounts according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, expected future cash flows, financial condition of the borrower, and the current economic conditions. A performing loan may be considered impaired if the factors above indicate a need for impairment. A loan on non-accrual status may not be impaired if it is in the process of collection or if the shortfall in payment is insignificant. A delay of less than 30 days or a shortfall of less than 5% of the required principal and interest payments generally is considered insignificant and would not indicate an impairment situation, if in management s judgment the loan will be paid in full. Loans that meet the regulatory definitions of doubtful or loss generally qualify as impaired loans under FASB Statement No. 114. As is the case for all loans, charge-offs for impaired loans occur when the loan or portion of the loan is determined to be uncollectible.

**Note 5. Company-Obligated Mandatorily Redeemable Capital Securities**

On March 26, 2002, the Company established a subsidiary trust that issued $4.0 million of capital securities as part of a pooled trust preferred security offering with other financial institutions ( Trust I ). The Company used the offering proceeds for the purposes of expansion and the repurchase of additional shares of its common stock. The interest rate on the capital security resets every three months at 3.60% above the then current three month LIBOR. Interest is paid quarterly. 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 wholly-owned Connecticut statutory business trust privately issued $4 million face amount of the trust s Floating Rate Capital Securities in a pooled capital securities offering ( Trust II ). Simultaneously, the trust used the proceeds of that sale to purchase $4.0 million principal amount of the Company s Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. The interest rate on the capital security resets every three months at 1.70% above the then current three month LIBOR. Interest is paid quarterly.

The purpose of the September 2006 Trust II issuance was to use the proceeds to redeem the existing capital securities of Trust I on March 26, 2007. Because of changes in the market pricing of capital securities from 2002 to 2006, the September 2006 issuance was priced 190 basis points less than that of the March 2002 issuance, and the repayment of the March 2002 issuance in March 2007 reduced the interest expense associated with the distribution on capital securities of subsidiary trust by $76,000 annually. The Company redeemed all the existing capital securities issued by Trust I on March 26, 2007.

Total capital securities at September 30, 2008 and 2007 were $4,124,000 for both respective dates. The Trust II issuance of capital securities and the respective subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

**Note 6. Earnings Per Share**

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

| Three Months Ended September 30, 2008 | | Three Months Ended September 30, 2007 | |
|---|---|---|---|
| Shares | Per Share Amount | Shares | Per Share Amount |
| 3,529,347 | $ 0.26 | 3,513,130 | $ 0.34 |
| 31,184 | | 45,179 | |
| 3,560,531 | $ 0.26 | 3,558,309 | $ 0.34 |

| Nine Months Ended September 30, 2008 | | Nine Months Ended September 30, 2007 | |
|---|---|---|---|
| Shares | Per Share Amount | Shares | Per Share Amount |
| 3,525,633 | $ 0.82 | 3,503,844 | $ 1.05 |
| 33,384 | | 63,522 | |
| 3,559,017 | $ 0.81 | 3,567,366 | $ 1.03 |

**Note 7. Stock-Based Compensation**

The Company has a stock-based compensation plan. Effective January 1, 2006 the Company adopted the provisions of Statement of Financial Accounting Standard ( SFAS ) No. 123 (R), Share-Based Payment, which requires that the Company recognize expense related to the fair value of stock-based compensation awards in net income.

The 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 over the next three years. Compensation expense for nonvested shares amounted to $68,952 and $64,545 for the three months ended September 30, 2008 and 2007, respectively. Compensation expense for nonvested shares amounted to $194,623 and $191,685 for the nine months ended September 30, 2008 and 2007, respectively.

The Company did not grant options during the three months or nine months ended September 30, 2008 and 2007.

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

| | Nine Months Ended September 30, 2008 | | |
|---|---|---|---|
| | Number of Shares | Weighted Average Exercise Price | Average Intrinsic Value (1) |
| Outstanding at January 1, 2008 | 96,100 | $ 9.85 | |

| | | | | |
|---|---|---|---|---|
| Granted | | | | |
| Exercised | (18,920) | | 9.91 | |
| Forfeited | | | | |
| Outstanding at September 30, 2008 | 77,180 | $ | 9.84 | $ 434,523 |
| Exercisable at end of quarter | 77,180 | $ | 9.84 | $ 434,523 |
| Weighted-average fair value per option of options granted during the year | | | | |

(1) The aggregate intrinsic value of stock options in the table above reflects the pre-tax intrinsic value (the amount by which the September 30, 2008 market value of the underlying stock option exceeded the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on September 30, 2008. This amount changes based on the changes in the market value of the Company s stock.

The total intrinsic value of options exercised during the nine months ended September 30, 2008 and 2007 was $132,774 and $1,207,531, respectively.

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

| | Nine Months Ended September 30, 2008 | |
|---|---|---|
| | Number of Shares | Weighted Average Exercise Price |
| Nonvested at January 1, 2008 | 31,190 | |
| Granted | 19,692 | $ 17.70 |
| Vested | (10,315) | |
| Forfeited, nonvested | (2,348) | $ 21.13 |
| Nonvested at September 30, 2008 | 38,219 | |

As of September 30, 2008, there was $402,988 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over an approximate period of 28 months.

**Note 8. Employee Benefit Plan**

The following table provides a reconciliation of the changes in the defined benefit pension plan s obligations for the three and nine months ended September 30, 2008 and 2007.

| | Three Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| Service cost | $ 111,081 | $ 167,680 |
| Interest cost | 77,352 | 100,343 |
| Expected return on plan assets | (149,050) | (111,378) |
| Amortization of transition (asset) | (4,745) | 1,942 |
| Amortization of prior service cost | 1,942 | (4,745) |
| Recognized net actuarial loss | | 5,258 |
| Net periodic benefit cost | $ 36,580 | $ 159,100 |

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| Service cost | $ 333,243 | $ 503,040 |
| Interest cost | 232,056 | 301,029 |
| Expected return on plan assets | (447,150) | (334,134) |
| Amortization of transition (asset) | (14,235) | 5,826 |
| Amortization of prior service cost | 5,826 | (14,235) |
| Recognized net actuarial loss | | 15,774 |
| Net periodic benefit cost | $ 109,740 | $ 477,300 |

The Company previously disclosed in its financial statements for the year ended December 31, 2007, that there were no contributions made to its pension plan in 2007. As of September 30, 2008, the pension plan required no additional contributions.

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

Defined benefit pension plan expenses are projected to decrease from $636,000 in 2007 to approximately $150,000 in 2008 and nothing in 2009 and going forward. Expenses for the 401(k) plan are projected to increase from $134,000 in 2007 to approximately $140,000 in 2008 and 2009, and approximately $625,000 in 2010. Growth in 401(k) after 2010 is projected to increase approximately at the same rate of increase as salaries.

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

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

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

For additional discussion of risk factors that may cause our actual future results to differ materially from the results indicated within forward-looking statements, please see Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

**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 3,566,286 shares of common stock, par value $3.13 per share, held by approximately 432 holders of record on September 30, 2008. 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 properties in Haymarket, Virginia and Bristow, Virginia, where it plans to build its ninth and tenth full-service branch offices, respectively, scheduled to open during 2009.

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

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

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

The Bank, through its subsidiary Fauquier Bank Services, Inc., has equity ownership interests in Bankers Insurance, LLC, a Virginia independent insurance company; Infinex Investments, Inc., a full service broker/dealer; and Bankers Title Shenandoah, LLC, a title insurance company. Bankers Insurance consists of a consortium of 36 Virginia community bank owners; Infinex is owned by 57 banks in various states; and Bankers Title Shenandoah is owned by 17 Virginia community banks. On April 30, 2008, the Bank s ownership of stock in BI Investments, LLC was exchanged for Infinex stock as part of a merger.

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

As is the case with banking institutions generally, the Bank s operations are materially and significantly influenced by general economic conditions and by related monetary and fiscal policies of financial institution regulatory agencies, including the Board of Governors of the Federal Reserve System ( Federal Reserve ). As a Virginia-chartered bank and a member of the Federal Reserve, the Bank is supervised and examined by the Federal Reserve and the Virginia State Corporation Commission. Interest rates on competing investments and general market rates of interest influence deposit flows and costs of funds. Lending activities are affected by the demand for financing of real estate and other types of loans, which in turn is affected by the interest rates at which such financing may be offered and other factors affecting local demand and availability of funds. The Bank faces strong competition in the attraction of deposits (its primary source of lendable funds) and in the origination of loans. Please see Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

As of September 30, 2008, the Company had total consolidated assets of $499.8 million, total loans net of allowance for loan losses of $423.1 million, total consolidated deposits of $405.6 million, and total consolidated shareholders equity of $40.6 million.

**CRITICAL ACCOUNTING POLICIES**

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

ALLOWANCE FOR LOAN LOSSES. The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on three basic principles of accounting: (i) 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) SEC Staff Accounting Bulletin No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues, which requires adequate documentation to support the allowance for loan losses estimate.

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

**EXECUTIVE OVERVIEW**

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

The Bank is the primary independent community bank in its immediate market area as measured by deposit market share. It seeks to be the primary financial service provider for its market area by providing the right mix of consistently high quality customer service, efficient technological support, value-added products, and a strong commitment to the community. The Company and the Bank s primary operating businesses are in commercial and retail lending, deposit accounts and core deposits, and assets under WMS management.

Net income of $935,000 for the third quarter of 2008 was a 22.7% decrease from the net income for the third quarter of 2007 of $1.21 million. Loans, net of reserve, totaling $423.1 million at September 30, 2008, increased 3.4% when compared with December 31, 2007, and increased 4.1% when compared with September 30, 2007. Deposits increased 0.3% compared with year-end 2007, and increased 1.8% when compared with September 30, 2007. Assets under WMS management, totaling $273.7 million in market value at September 30, 2008, declined 7.9% from $297.1 million in market value at September 30, 2007, primarily due to the decline in valuations of common stock under management. For example, from September 30, 2007 to September 30, 2008, stocks measured in the Standard & Poors 500 index declined by approximately 24.6%.

Net interest income is the largest component of net income, and equals the difference between income generated on interest-earning assets and interest expense incurred on interest-bearing liabilities. Future trends regarding net interest income are dependent on the absolute level of market interest rates, the shape of the yield curve, the amount of lost income from non-performing assets, the amount of prepaying loans, the mix and amount of various deposit types, competition for loans and deposits, and many other factors, as well as the overall volume of interest-earning assets. These factors are individually difficult to predict, and when taken together, the uncertainty of future trends compounds. Based on management s current projections, net interest income may increase in 2008 and beyond as average interest-earning assets increase, but this may be offset in part or in whole by a possible contraction in the Bank s net interest margin resulting from competitive market conditions and/or a flat or inverted yield curve. A steeper yield curve is projected to result in an increase in net interest income, while a flatter or inverted yield curve is projected to result in a decrease in net interest income.

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

The Bank s non-performing assets totaled $4.6 million or 1.07% of total loans at September 30, 2008, as compared with $2.1 million or 0.51% of total loans at December 31, 2007, and $1.38 million or 0.34% of total loans at September 30, 2007. The provision for loan losses was $431,000 for the third quarter of 2008 compared with $120,000 for the third quarter of 2007. Loan chargeoffs, net of recoveries, totaled $1.22 million or 0.29% of total loans for the first nine months of 2008, compared with $417,000 or 0.11% of total loans for the first nine months of 2007. The $311,000 increase in the provision for loan losses from third quarter 2007 to third quarter 2008 was largely in response to the increase in net loans and non-performing assets. Total allowance for loan losses was $4.7 million or 1.10% of total loans at September 30, 2008 compared with $4.2 million or 1.01% of loans at December 31, 2007.

Management seeks to continue the expansion of its branch network. The Bank has leased properties in Haymarket, Virginia and Bristow, Virginia, where it plans to build its ninth and tenth full-service branch offices, respectively, both scheduled to open in 2009. The Bank is looking toward these new retail markets for growth in deposits and WMS income. Management seeks to increase the level of its fee income from deposits and WMS through the increase of its market share within its marketplace.

**COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2008 AND SEPTEMBER 30, 2007**

**NET INCOME**

Net income was $935,000 for the third quarter of 2008, a 22.7% decrease from the third quarter of 2007 net income of $1.21 million. Earnings per share on a fully diluted basis were $0.26 in 2008 compared to $0.34 in 2007. Profitability as measured by return on average equity decreased from 11.68% in the third quarter of 2007 to 8.85% for the same period in 2008. Profitability as measured by return on average assets decreased from 0.99% to 0.73% over the same respective quarters in 2007 and 2008. The decline in net income and the corresponding profitability measures was primarily due to the increase in the provision for loan losses of $311,000 in the third quarter of 2008 compared with the third quarter of 2007, as well as a $298,000 permanent impairment loss on the Bank s investment in Freddie Mac preferred stock.

**NET INTEREST INCOME AND EXPENSE**

Net interest income increased $241,000 or 5.2% to $4.85 million for the quarter ended September 30, 2008 from $4.61 million for the quarter ended September 30, 2007. The increase in net interest income was due to the Company s net interest margin increasing from 4.02% in the third quarter of 2007 to 4.10% in the third quarter of 2008, primarily due to the positively sloped yield curve during the third quarter of 2008 compared with the flat and inverted yield curve during the third quarter of 2007. (A positively sloped yield curve is where the interest rate on longer-termed financial instruments exceeds the interest rate on shorter-termed financial instruments, all other factors being equal, while with an inverted yield curve, shorter-termed financial instruments have higher interest rates than longer-termed financial instruments.) The benefit of the positively sloped yield curve was partially offset by competitive pricing pressures, particularly on deposits. In addition, net interest income increased due to the impact of total average earning assets increasing from $454.0 million during the third quarter of 2007 to $470.9 million during the third quarter of 2008.

The net interest margin pressure caused by the economic environment of a flat and inverted yield curve proved to be challenging for the Bank during much of 2007. At September 30, 2004, just as the Federal Reserve s Federal Open Market Committee (the FMOC ) began raising the federal funds rate, the yield on a three month maturity treasury bond was 1.37% or 253 basis points below the 3.90% yield on a five year treasury and 332 basis points below the 4.69% yield on a 10 year treasury. At October 30, 2006, that yield had inverted to the point that a three month treasury was yielding 5.12%, while the five year and ten year treasury were yielding 4.74% and 4.77%, respectively. The yield curve changed from a more than 250 basis point premium for a longer investment to a position where there is no premium or, in fact, a discount. This presented funding and interest margin management pressures, as a flat or inverted yield curve significantly increased competition for deposits and their cost. While deposit costs rapidly increased, the lack of a similar movement in longer-term rates limited the yield increase on fixed rate loans.

The economic environment changed direction during the fourth quarter of 2007, when the FMOC began lowering the federal funds rate, and the shape of the yield curve became less flat and more positively sloped. Through September 30, 2008, the FMOC has continued the reduction of the federal funds rate. At September 30, 2008, the yield on a three month maturity treasury security was 0.92% or 206 basis points below the 2.98% yield on a five year treasury and 293 basis points below the 3.85% yield on a 10 year treasury. As a result, the Company s net interest margin improved from 4.02% for the third quarter of 2007 to 4.10% for the third quarter of 2008. Offsetting the benefit of the positively sloped yield curve during the third quarter of 2008 has been the significant increase in competitive pricing for retail deposits.

Total interest income decreased $505,000 or 6.6% to $7.20 million for the third quarter of 2008 from $7.71 million for the third quarter of 2007. This decrease was primarily due to the 65 basis point decrease in the yield on average assets from third quarter 2007 to third quarter 2008. This was partially offset by the increase in total average earning assets of $16.9 million or 3.7%.

The average yield on loans decreased to 6.17% for the third quarter of 2008 compared with 6.90% for the third quarter of 2007. Average loan balances increased 4.0% from $412.7 million during the third quarter of 2007 to $429.4 million during the third quarter of 2008. Together, this resulted in a $527,000 or 7.3% decrease in interest and fee income from loans for the third quarter of 2008 compared with the same period in 2007.

Average investment security balances decreased $1.1 million from $39.3 million in the third quarter of 2007 to $38.2 million in the third quarter of 2008. The tax-equivalent average yield on investments increased from 4.85% for the third quarter of 2007 to 5.39% for the third quarter of 2008. Together, there was an increase in interest and dividend income on security investments of $27,000 or 5.9%, from $458,000 for the third quarter of 2007 to $485,000 for the third quarter of 2008. Interest income on federal funds sold decreased $15,000 from the third quarter of 2007 to the third quarter of 2008, reflecting a decline in the average balances from $1.3 million to nothing.

Total interest expense decreased $746,000 or 24.1% from $3.10 million for the third quarter of 2007 to $2.35 million for the third quarter of 2008 primarily due to the overall decline in shorter-term market interest rates. Interest paid on deposits decreased $781,000 or 30.7% from $2.54 million for the third quarter of 2007 to $1.76 million for the third quarter of 2008. Average Premium money market account balances decreased $9.6 million from third quarter 2007 to third quarter 2008, while their average rate decreased from 4.10% to 2.07% over the same period resulting in a decrease of $453,000 of interest expense for the third quarter of 2008. Average time deposit balances increased $1.9 million from third quarter of 2007 to the third quarter of 2008 while the average rate on time deposits decreased from 4.43% to 3.52% resulting in a decrease of $267,000 in interest expense for the third quarter of 2008. Average NOW deposit balances increased $11.7 million from the third quarter of 2007 to the third quarter of 2008 while the average rate on NOW accounts decreased from 1.30% to 0.90% resulting in a reduction of $45,000 in NOW interest expense for the third quarter of 2008.

Interest expense on federal funds purchased decreased $22,000 for the third quarter of 2008 when compared to the third quarter of 2007 due to the decline in the average fed funds rate from 5.76% to 2.40%, partially offset by the $807,000 increase in average federal funds purchased. Interest expense on FHLB of Atlanta advances increased $84,000 from the third quarter of 2007 to the third quarter of 2008 due to the increase in average FHLB advance balances of $25.7 million, mostly offset by the decrease in the average rate paid on FHLB advances from 5.30% to 3.51%. The average rate on total interest-bearing liabilities decreased from 3.32% for the third quarter of 2007 to

2.36% for the third quarter of 2008.

The following table sets forth information relating to the Company s average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated and the average yields and rates paid for the periods indicated. These yields and costs are derived by dividing income or expense by the average daily balances of assets and liabilities, respectively, for the periods presented.

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

| | Three Months Ended September 30, 2008 | | | Three Months Ended September 30, 2007 | | |
|---|---|---|---|---|---|---|
| | **Average Balances** | **Income/ Expense** | **Average Rate** | **Average Balances** | **Income/ Expense** | **Average Rate** |
| **ASSETS:** | | | | | | |
| Loans | | | | | | |
| Taxable | $ 417,624 | $ 6,596 | 6.19% | $ 404,429 | $ 7,137 | 6.90% |
| Tax-exempt (1) | 8,642 | 159 | 7.21% | 7,536 | 139 | 7.17% |
| Nonaccrual (2) | 3,089 | | | 744 | | |
| Total Loans | 429,355 | 6,755 | 6.17% | 412,709 | 7,276 | 6.90% |
| Securities | | | | | | |
| Taxable | 32,970 | 427 | 5.17% | 36,024 | 420 | 4.66% |
| Tax-exempt (1) | 5,265 | 88 | 6.71% | 3,299 | 57 | 6.94% |
| Total securities | 38,235 | 515 | 5.39% | 39,323 | 477 | 4.85% |
| Deposits in banks | 3,269 | 15 | 1.83% | 641 | 5 | 3.25% |
| Federal funds sold | | | | 1,289 | 15 | 4.69% |
| Total earning assets | 470,859 | 7,285 | 6.08% | 453,962 | 7,773 | 6.72% |
| Less: Reserve for loan losses | (4,491) | | | (4,414) | | |
| Cash and due from banks | 14,658 | | | 14,292 | | |
| Bank premises and equipment, net | 8,451 | | | 7,350 | | |
| Other assets | 17,501 | | | 16,093 | | |
| Total Assets | $ 506,978 | | | $ 487,283 | | |
| **LIABILITIES & SHAREHOLDERS EQUITY:** | | | | | | |
| Deposits | | | | | | |
| Demand deposits | $ 66,170 | | | $ 73,072 | | |
| Interest-bearing deposits | | | | | | |
| NOW accounts | 82,685 | 186 | 0.90% | 70,966 | 232 | 1.30% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Money market accounts | 20,447 | 74 | 1.43% | 25,112 | 92 | 1.45% |
| Premium money market accounts | 68,990 | 359 | 2.07% | 78,628 | 812 | 4.10% |
| Savings accounts | 31,748 | 39 | 0.49% | 32,173 | 34 | 0.43% |
| Time deposits | 124,902 | 1,104 | 3.52% | 122,956 | 1,372 | 4.43% |
| Total interest-bearing deposits | 328,772 | 1,762 | 2.13% | 329,835 | 2,542 | 3.06% |
| Federal funds purchased | 3,953 | 24 | 2.40% | 3,146 | 46 | 5.76% |
| Federal Home Loan Bank advances | 57,880 | 519 | 3.51% | 32,207 | 436 | 5.30% |
| Capital securities of subsidiary trust | 4,124 | 46 | 4.34% | 4,124 | 73 | 6.89% |
| Total interest-bearing liabilities | 394,729 | 2,351 | 2.36% | 369,312 | 3,097 | 3.32% |
| Other liabilities | 4,041 | | | 3,811 | | |
| Shareholders equity | 42,038 | | | 41,088 | | |
| Total Liabilities & Shareholders Equity | $ 506,978 | | | $ 487,283 | | |
| Net interest spread | | $ 4,934 | 3.72% | | $ 4,676 | 3.40% |
| Interest expense as a percent of average earning assets | | | 1.98% | | | 2.70% |
| Net interest margin | | | 4.10% | | | 4.02% |

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

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

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**RATE/VOLUME ANALYSIS**

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

| | **RATE / VOLUME VARIANCE (In Thousands)** Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007 | | |
|---|---|---|---|
| | **Change** | **Due to Volume** | **Due to Rate** |
| INTEREST INCOME | | | |
| Loans; taxable | $ (541) | $ 190 | $ (731) |
| Loans; tax-exempt (1) | 20 | 20 | |
| Securities; taxable | 7 | (33) | 40 |
| Securities; tax-exempt (1) | 31 | 34 | (3) |
| Deposits in banks | 10 | 22 | (12) |
| Federal funds sold | (15) | (15) | |
| Total Interest Income | (488) | 218 | (706) |
| INTEREST EXPENSE | | | |
| NOW accounts | (46) | 38 | (84) |
| Money market accounts | (18) | (17) | (1) |
| Premium money market accounts | (453) | (100) | (353) |
| Savings accounts | 5 | | 5 |
| Time deposits | (268) | 22 | (290) |
| Federal funds purchased and securities sold under agreements to repurchase | (22) | 12 | (34) |
| Federal Home Loan Bank advances | 83 | 348 | (265) |
| Capital securities of subsidiary trust | (27) | | (27) |
| Total Interest Expense | (746) | 303 | (1,049) |
| Net Interest Income | $ 258 | $ (85) | $ 343 |

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

of 34%.

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

The provision for loan losses was $431,000 for the third quarter of 2008, compared with $120,000 for the third quarter of 2007. The amount of the provision for loan loss was based upon management s continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank s delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. Greater weight is given to the loss history by loan category, prolonged changes in portfolio delinquency trends by loan category, and changes in economic trends. There can be no assurances, however, that future losses will not exceed estimated amounts, or that increased amounts of provisions for loan losses will not be required in future periods.

The $311,000 increase in the provision for loan losses during the third quarter 2008, compared to the same quarter one year earlier, was largely in response to the growth of loans during the quarter ended September 30, and the growth in non-performing assets.

**OTHER INCOME**

Total other income decreased by $287,000 from $1.54 million for the third quarter of 2007 to $1.25 million in the third quarter of 2008. Non-interest income is derived primarily from non-interest fee income, which consists primarily of fiduciary and other Wealth Management fees, service charges on deposit accounts, and other fee income. The decrease in other income primarily reflects loss on securities which reflect the recognition of a permanent impairment on its investment in Freddie Mac preferred stock of $298,000.

Wealth Management income decreased $34,000 or 9.4% from third quarter 2007 to third quarter 2008, as assets under management declined from year to year, in part due to the decline in overall stock market valuations. Service charges on deposit accounts increased $1,000 or 0.1% to $763,000 for the second three months of 2008. Other service charges, commissions and fees increased $46,000 or 10.9% from $417,000 in third quarter 2007 to $463,000 in third quarter 2008 primarily due to increased rental income and VISA check card income. Also included in other service charges, commissions, and income is Bank Owned Life Insurance ( BOLI ) income, which was $104,000 during the third quarter of 2008 compared with $100,000 one year earlier. Total BOLI was $10.3 million at September 30, 2008, compared with $9.9 million one year earlier.

Management seeks to increase the level of its future fee income from wealth management services and deposits through the increase of its market share within its marketplace. Wealth Management fees are projected to grow at a pace closer to the 3% to 5% growth seen in 2007, rather than the 1% growth seen in 2006 and the decline in growth for the first nine months of 2008. Fees from deposits are projected to continue to grow at a 4% to 7% rate, which reflects the projected growth for retail (non-commercial) core deposits.

**OTHER EXPENSE**

Total other expense decreased $27,000 or 0.6% during the third quarter of 2008 compared with the third quarter of 2007. Salaries and employees benefits decreased $154,000, or 6.7%, primarily due to decreases in the accrued expense for the 2008 incentive compensation plan, and the defined benefit pension plan, partially offset by the customary annual salary increases. Active full-time equivalent personnel totaled 144 at September 30, 2008 compared with 143 at September 30, 2007.

On December 20, 2007, the Company s Board of Directors ( Board ) approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010 the Board approved to replace the defined benefit pension plan with an enhanced 401(k) plan. Defined benefit pension plan expenses are projected to decrease from $636,000 in 2007 to approximately $150,000 in 2008 and nothing in 2009 and going forward. Expenses for the 401(k) plan are projected to increase from $134,000 in 2007 to approximately $140,000 in 2008 and 2009, and approximately $625,000 in 2010. Growth in 401(k) after 2010 is projected to increase approximately at the same rate of increase as salaries.

The Bank expects personnel costs, consisting primarily of salary and benefits, to continue to be its largest other expense. As such, the most important factor with regard to potential changes in other expenses is the expansion of staff. The cost of any additional staff expansion, however, would be expected to be offset by the increased revenue generated by the additional services that the new staff would enable the Bank to perform. For the remainder of 2008, the Company projects the increase of approximately three new full-time equivalent positions in addition to filling four currently vacant positions. These new positions are planned in commercial lending and technology systems support. In 2009, the Company will increase full-time equivalent personnel in order to staff two new branch offices in Haymarket and Bristow.

Net occupancy expense increased $63,000 or 23.4%, and furniture and equipment expense increased $8,000 or 2.5%, from third quarter 2007 to third quarter 2008. The increase in occupancy expense primarily reflects increased maintenance and repair expenses as well as increased rent expense due to the newly-leased View Tree branch.

Marketing expense increased $3,000 or 2.3% from $140,000 for the third quarter of 2007 to $143,000 for the third quarter of 2008. These expenses primarily reflect the continuation of direct mail campaigns targeting both individual households and small businesses.

Consulting expense, which includes legal and accounting professional fees, increased $34,000 or 15.1% in the third quarter of 2008 compared with the third quarter of 2007. This increase primarily reflects increased legal fees associated with impaired loans and real estate owned.

Data processing expense decreased $19,000 or 5.4% for the third quarter of 2008 compared with the same time period in 2007. The Bank outsources much of its data processing to a third-party vendor.

Other operating expenses increased $37,000 or 5.2% in third quarter 2008 compared with third quarter 2007. The increase in expense primarily reflects an increase in FDIC deposit insurance expense.

**INCOME TAXES**

Income tax expense was $479,000 for the quarter ended September 30, 2008 compared with $534,000 for the quarter ended September 30, 2007. The effective tax rates were 33.9% and 30.6% for the third quarter of 2008 and 2007, respectively. The effective tax rate differs from the statutory federal income tax rate of 34% due to the Bank s investment in tax-exempt loans and securities, and income from the BOLI purchases, partially offset by the lack of capital gains to offset the capital loss on the Freddie Mac preferred stock. Additionally, the reduction in income taxes associated with the impairment loss taken on Freddie Mac preferred stock of $101,000 will take place in the fourth quarter of 2008, and not during the third quarter of 2008, as provided for by the Troubled Asset Relief Program ( TARP ) approved by the U. S. Congress on October 3, 2008, and in order to be in compliance with FAS109 Accounting for Income Taxes. Had the $101,000 tax benefit on the impairment loss been taken in the third quarter of 2008, the effective tax rate would have been 26.7%.

**COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008 AND SEPTEMBER 30, 2007**

**NET INCOME**

Net income was $2.89 million for the first nine months of 2008, a 21.2% decrease from the first nine months of 2007 net income of $3.66 million. Earnings per share on a fully diluted basis were $0.81 in 2008 compared to $1.03 in 2007. Profitability as measured by return on average equity decreased from 12.11% in the first nine months of 2007 to 9.04% for the same period in 2008. Profitability as measured by return on average assets decreased from 1.00% to 0.77% over the same respective nine month periods in 2007 and 2008. The decline in net income and the corresponding profitability measures was primarily due to the increase in the provision for loan losses of $1.36 million in the first nine months of 2008 compared with the first nine months of 2007, as well as the $423,000 impairment loss on the Bank s Freddie Mac preferred stock investment.

**NET INTEREST INCOME AND EXPENSE**

Net interest income increased $522,000 or 3.8% to $14.41 million for the nine months ended September 30, 2008 from $13.89 million for the nine months ended September 30, 2007. The increase in net interest income was due to the Company s net interest margin increasing from 4.03% during the first nine months of 2007 to 4.15% in the first nine months of 2008, primarily due to the positively sloped yield curve during the first nine months of 2008 compared with the flat and inverted yield curve during the first nine months of 2007.

Total interest income decreased $1.68 million or 7.2% to $21.54 million for the first nine months of 2008 from $23.21 million for the first nine months of 2007. This decrease was primarily due to the 54 basis point decrease in the yield on average assets from first nine months of 2007 to first nine months of 2008, partially offset by the increase in total average earning assets of $4.3 million or 0.9%.

The average yield on loans decreased to 6.33% for the first nine months of 2008 compared with 6.95% for the first nine months of 2007. Average loan balances increased 1.2% from $415.7 million during the first nine months of 2007 to $420.8 million during the first nine months of 2008. Together, this resulted in a $1.65 million or 7.6% decrease in interest and fee income from loans for the first nine months of 2008 compared with the same period in 2007.

Average investment security balances decreased $884,000 from $38.9 million in the first nine months of 2007 to $38.1 million in the first nine months of 2008. The tax-equivalent average yield on investments increased from 4.79% for the first nine months of 2007 to 5.17% for the first nine months of 2008. Together, there was an increase in interest and dividend income on security investments of $20,000 or 1.5%, from $1.37 million for the first nine months of 2007 to $1.39 million for the first nine months of 2008. Interest income on federal funds sold decreased $49,000 from the first nine months of 2007 to the first nine months of 2008, reflecting a decline in the average yield from 5.02% to 2.71%.

Total interest expense decreased $2.20 million or 23.6% from $9.33 million for the first nine months of 2007 to $7.13 million for the first nine months of 2008 primarily due to the overall decline in shorter-term market interest rates. Interest paid on deposits decreased $2.02 million or 26.9% from $7.50 million for the first nine months of 2007 to $5.49 million for the first nine months of 2008. Average Premium money market account balances increased $2.6 million from $69.0 million for the first nine months of 2007 to $71.6 million for the first nine months 2008, while their average rate decreased from 4.10% to 2.37% over the same period resulting in a decrease of $844,000 of interest expense for the first nine months of 2008. Average time deposit balances decreased $15.1 million from first nine months of 2007 to the same period of 2008 while the average rate on time deposits decreased from 4.50% to 3.76% resulting in a decrease of $1.14 million in interest expense for the first nine months of 2008. Average NOW deposit balances increased $14.8 million from the first nine months of 2007 to the first nine months of 2008 while the average rate on NOW accounts decreased from 1.23% to 1.02% resulting in a reduction of $3,000 in interest expense for the first nine months of 2008.

Interest expense on federal funds purchased decreased $97,000 for the first nine months of 2008 when compared to the first nine months of 2007 due to the $370,000 decrease in average federal funds purchased and the decline in the average fed funds rate from 5.65% to 2.93%. Interest expense on FHLB of Atlanta advances increased $61,000 from the first nine months of 2007 to the first nine months of 2008 due to the increase in average FHLB advance balances of $17.0 million partially offset by the decrease in the average rate paid on FHLB advances from 5.20% to 3.61%, by over the same period. The average rate on total interest-bearing liabilities decreased from 3.34% for the first nine months of 2007 to 2.47% for the first nine months of 2008.

The following table sets forth information relating to the Company s average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated and the average yields and rates paid for the periods indicated. These yields and costs are derived by dividing income or expense by the average daily balances of assets and liabilities, respectively, for the periods presented.

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

| | Nine Months Ended September 30, 2008 | | | Nine Months Ended September 30, 2007 | | |
|---|---|---|---|---|---|---|
| | Average Balances | Income/ Expense | Average Rate | Average Balances | Income/ Expense | Average Rate |
| **ASSETS:** | | | | | | |
| Loans | | | | | | |
| Taxable | $ 410,676 | $ 19,805 | 6.31% | $ 406,667 | $ 21,462 | 6.95% |
| Tax-exempt (1) | 7,916 | 433 | 7.18% | 7,697 | 419 | 7.18% |
| Nonaccrual (2) | 2,244 | | | 1,313 | | |
| Total Loans | 420,836 | 20,238 | 6.33% | 415,677 | 21,881 | 6.95% |
| Securities | | | | | | |
| Taxable | 32,675 | 1,211 | 4.71% | 37,071 | 1,299 | 4.63% |
| Tax-exempt (1) | 5,386 | 265 | 6.55% | 1,874 | 102 | 7.25% |
| Total securities | 38,061 | 1,476 | 5.17% | 38,945 | 1,401 | 4.79% |
| Deposits in banks | 1,693 | 28 | 2.16% | 1,192 | 26 | 2.87% |
| Federal funds sold | 1,640 | 33 | 2.71% | 2,155 | 82 | 5.02% |
| Total earning assets | 462,230 | 21,775 | 6.21% | 457,969 | 23,390 | 6.75% |
| Less: Reserve for loan losses | (4,285) | | | (4,471) | | |
| Cash and due from banks | 15,550 | | | 14,854 | | |
| Bank premises and equipment, net | 8,160 | | | 7,449 | | |
| Other assets | 16,825 | | | 15,792 | | |
| Total Assets | $ 498,480 | | | $ 491,593 | | |
| **LIABILITIES & SHAREHOLDERS EQUITY:** | | | | | | |
| Deposits | | | | | | |
| Demand deposits | $ 67,617 | | | $ 74,823 | | |
| Interest-bearing deposits | | | | | | |
| NOW accounts | 86,067 | 655 | 1.02% | 71,263 | 658 | 1.23% |
| Money market accounts | 22,547 | 244 | 1.44% | 26,594 | 286 | 1.44% |
| Premium money market accounts | 71,595 | 1,273 | 2.37% | 68,988 | 2,117 | 4.10% |
| Savings accounts | 31,363 | 111 | 0.47% | 33,216 | 103 | 0.41% |
| Time deposits | 113,762 | 3,202 | 3.76% | 128,880 | 4,341 | 4.50% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total interest-bearing deposits | 325,334 | 5,485 | 2.25% | 328,941 | 7,505 | 3.05% |
| Federal funds purchased | 3,984 | 87 | 2.93% | 4,354 | 184 | 5.65% |
| Federal Home Loan Bank advances | 50,961 | 1,401 | 3.61% | 33,967 | 1,340 | 5.20% |
| Capital securities of subsidiary trust | 4,124 | 156 | 4.95% | 5,453 | 300 | 7.26% |
| Total interest-bearing liabilities | 384,403 | 7,129 | 2.47% | 372,715 | 9,328 | 3.34% |
| Other liabilities | 3,829 | | | 3,640 | | |
| Shareholders equity | 42,631 | | | 40,415 | | |
| Total Liabilities & Shareholders Equity | $ 498,480 | | | $ 491,593 | | |
| Net interest spread | | $ 14,646 | 3.74% | | $ 14,061 | 3.41% |
| Interest expense as a percent of average earning assets | | | 2.05% | | | 2.72% |
| Net interest margin | | | 4.15% | | | 4.03% |

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

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

**RATE/VOLUME ANALYSIS**

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

| | RATE / VOLUME VARIANCE (In Thousands) Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007 | | |
|---|---|---|---|
| | **Change** | **Due to Volume** | **Due to Rate** |
| INTEREST INCOME | | | |
| Loans; taxable | $ (1,657) | $ (125) | $ (1,532) |
| Loans; tax-exempt (1) | 14 | 12 | 2 |
| Securities; taxable | (88) | (109) | 21 |
| Securities; tax-exempt (1) | 163 | 191 | (28) |
| Deposits in banks | 2 | 11 | (9) |
| Federal funds sold | (49) | (20) | (29) |
| Total Interest Income | (1,615) | (40) | (1,575) |
| INTEREST EXPENSE | | | |
| NOW accounts | (3) | 137 | (140) |
| Money market accounts | (42) | (43) | 1 |
| Premium money market accounts | (844) | 80 | (924) |
| Savings accounts | 8 | (6) | 14 |
| Time deposits | (1,139) | (509) | (630) |
| Federal funds purchased and securities sold under agreements to repurchase | (97) | (16) | (81) |
| Federal Home Loan Bank advances | 61 | 670 | (609) |
| Capital securities of subsidiary trust | (144) | (73) | (71) |
| Total Interest Expense | (2,200) | 240 | (2,440) |
| Net Interest Income | $ 585 | $ (281) | $ 866 |

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

of 34%.

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

The provision for loan losses was $1.72 million for the first nine months of 2008, compared with $360,000 for the first nine months of 2007. The amount of the provision for loan loss was based upon management s continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank s delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. Greater weight is given to the loss history by loan category, prolonged changes in portfolio delinquency trends by loan category, and changes in economic trends. There can be no assurances, however, that future losses will not exceed estimated amounts, or that increased amounts of provisions for loan losses will not be required in future periods.

The increase in the provision for loan losses during the first nine months 2008 was largely in response to the amount of net loan chargeoffs and growth in non-performing assets during the same period. Loan chargeoffs, net of recoveries, totaled $1.22 million or 0.29% of total loans for the first nine months of 2008, compared with $417,000 or 0.10% of total loans for the first nine months of 2007.

**NON-INTEREST INCOME**

Total non-interest income decreased by $4,000 to $4.47 million for the first nine months of 2008 compared with the same nine months of 2007. Non-interest income is derived primarily from non-interest fee income, which consists primarily of fiduciary and other Wealth Management fees, service charges on deposit accounts, and other fee income. Included in the nine months was an impairment loss of $423,000 on the Freddie Mac preferred stock, as well as gains of $122,000 from the Bank s activities in the partial ownership in finance-related limited liability corporations, and a gain of $88,000 on the sale of investment securities.

Wealth Management income decreased $52,000 or 4.9% from the first nine months of 2007 to the first nine months of 2008, as assets under management decreased due to the decline of their market valuation. Service charges on deposit accounts increased $84,000 or 3.9% to $2.22 million for the first nine months of 2008, compared with $2.14 million for the same period in 2007 due to the increase in the number of transaction accounts generating fee income. Other service charges, commissions and fees increased $274,000 or 21.3% from $1.28 million during the first nine months of 2007 to $1.56 million in the first nine months of 2008 primarily due to the recognition of the net gain in the value of the Bank s partial ownership in four different entities, primarily a $217,000 gain due to the Bank s ownership interest in Infinex, a full service broker/dealer. On April 30, 2008, Infinex merged with Bankers Investments Group, LLC. As part of the merger, equity was infused by new participants, which in turn, recapitalized the Bank s existing ownership position. Also included in other service charges, commissions, and income is BOLI income, which was $310,000 during the first nine months of 2008 compared with $293,000 one year earlier.

For the nine months ended September 30, 2008, the Bank had an impairment loss of $423,000 on the Freddie Mac preferred stock. In addition, the Bank realized gains from sales of three securities available for sale of $88,000. The proceeds from the sale of the three securities, including the realized gain, amounted to $9.1 million. Two of the securities, totaling approximately $7.0 million, had a remaining maturity of less than seven months, while the third security, totaling $2.0 million, had a remaining maturity of 18 months. The proceeds of the sale were redeployed into securities with an average assumed life of approximately five years. There were no securities sold in the third quarter of 2008 and for all of 2007. Management does not project any further gains or losses on the sale of securities at this time.

**NON-INTEREST EXPENSE**

Total non-interest expense increased $309,000 or 2.4% during the first nine months of 2008 compared with the first nine months of 2007.

Salaries and employees benefits decreased $188,000, or 2.7%, primarily due to the decreases in the accrued expense for the 2008 incentive compensation plan and the defined benefit pension plan, partially offset by the customary annual salary increases.

Net occupancy expense increased $160,000 or 20.1%, and furniture and equipment expense decreased $4,000 or 0.5%, from the first nine months 2007 to the first nine months of 2008. The increase in occupancy expense primarily reflects increased maintenance and repair expenses as well as rent expense for the View Tree property. The decrease in furniture and equipment expenses primarily reflects the decrease in computer software depreciation expense.

Marketing expense increased $47,000 or 11.1% from $422,000 for the first nine months of 2007 to $468,000 for the first nine months of 2008. This increase primarily reflects in implementation of direct mail campaign targeting small businesses.

Consulting expense, which includes legal and accounting professional fees, increased $142,000 or 21.5% for the first nine months of 2008 compared with the first nine months of 2007. This increase primarily reflects the use of information technology consultants assisting the Bank with its technology planning and contract negotiations, as well as increased legal fees associated with impaired loans.

Data processing expense increased $31,000 or 3.2% for the first nine months of 2008 compared with the same time period in 2007. The Bank outsources much of its data processing to a third-party vendor. The increase in expense primarily reflects increased deposit transactions and other data processing system usage by the Bank.

Other operating expenses increased $122,000 or 6.0% in first nine months of 2008 compared with first nine months of 2007. This primarily reflects increases in non-loan chargeoffs and contributions to community organizations.

**INCOME TAXES**

Income tax expense was $1.22 million for the nine months ended September 30, 2008 compared with $1.60 million for the nine months ended September 30, 2007. The effective tax rates were 29.8% and 30.4% for the first nine months of 2008 and 2007, respectively.

**COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2008 AND DECEMBER 31, 2007**

Total assets were $499.8 million at September 30, 2008 compared with $489.9 million at December 31, 2007, an increase of 2.0% or $9.9 million. Balance sheet categories reflecting significant changes included cash and due from banks, total loans, bank premises and equipment, deposits, FHLB 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 $13.7 million at September 30, 2008, reflecting a decrease of $3.0 million from December 31, 2007. The decrease in cash and due from banks was primarily due to the decline in cash held at the Federal Reserve. The higher balance at December 31, 2007 was in order to satisfy reserve requirements.

LOANS. Total net loan balance after allowance for loan losses was $423.1 million at September 30, 2008, which represents an increase of $14.0 million or 3.4% from $409.1 million at December 31, 2007. The Bank continually modifies its loan pricing strategies and expands its loan product offerings in an effort to increase lending activity without sacrificing the existing credit quality standards.

BANK PREMISES AND EQUIPMENT, NET. Total bank premises and equipment, net, increased $1.2 million primarily due to purchase of land along Business Route 29 in Warrenton, VA for the purpose of relocating its ViewTree Warrenton branch office.

DEPOSITS. For the nine months ended September 30, 2008, total deposits increased by $1.1 million or 0.3% when compared with total deposits at December 31, 2007. Non-interest-bearing deposits decreased by $10.9 million and interest-bearing deposits increased by $12.0 million. Included in interest-bearing deposits at September 30, 2008 and December 31, 2007 were $38.7 million and $9.3 million, respectively of brokered deposits as defined by the Federal Reserve. Of the $38.7 million in brokered deposits, $28.7 million represent deposits of TFB customers, exchanged through the CDAR s network. With the CDAR s program, funds are placed into certificate of deposits issued by other banks in the network, in increments of less than $100,000, to ensure both principal and interest are eligible for complete FDIC coverage. These deposits are exchanged with other member banks on a dollar-for-dollar basis, bringing the full amount of our customers deposits back to the bank and making these funds fully available for lending in our community. The decline in the Bank s non-interest-bearing deposits and the increase in interest-bearing deposits during the first nine months of 2008 were the result of many factors difficult to segregate and quantify, and equally difficult to use as factors for future projections. The economy, local competition, retail customer preferences, changes in seasonal cash flows by both commercial and retail customers, changes in business cash management practices by Bank customers, the relative pricing from wholesale funding sources, and the Bank s funding needs all contributed to the change in deposit balances. The Bank projects to increase its transaction accounts and other deposits in 2008 and beyond through the expansion of its branch network, as well as by offering value-added NOW and demand deposit products, and selective rate premiums on its interest-bearing deposits.

FEDERAL HOME LOAN BANK ADVANCES. Federal funds purchased and FHLB advances increased by $10.0 million during the nine months ended September 30, 2008, to offset the decline in deposit balances.

COMPANY-OBLIGATED MANDATORILY REDEEMABLE CAPITAL SECURITIES OF SUBSIDIARY TRUST ( capital securities ). On March 26, 2002, the Company established a subsidiary trust that issued $4.0 million of capital securities as part of a pooled trust preferred security offering with other financial institutions. 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 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. 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 in March 2007 reduced the interest expense associated with the distribution on capital securities of subsidiary trust by $76,000 annually.

**ASSET QUALITY**

Non-performing 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 borrowers that have suffered financial distress, to determine if they should be placed on non-accrual status. Factors considered by management include the net realizable value of collateral, if any, and other resources of the borrower that may be available to satisfy the delinquency.

Loans are placed on non-accrual status when they have been specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loans are well secured and in the process of collection. Any unpaid interest previously accrued on such loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other non-accrual loans is recognized only to the extent of interest payments received.

Non-performing assets totaled $4.6 million or 1.07% of total loans at September 30, 2008, compared with $2.1 million or 0.51% of total loans at December 31, 2007, and $1.4 million, or 0.34% of total loans at September 30, 2007. There were $1,000 past due 90 days or more and still accruing interest at September 30, 2008. Total loans past due 90 days or more and still accruing interest were $770,000; and $165,000 on December 31, 2007, and September 30, 2007, respectively. There are no loans, other than those disclosed above as either non-performing or impaired, where information known about the borrower has caused management to have serious doubts about the borrower s ability to repay.

At September 30, 2008, there are no other interest-bearing assets that would be subject to disclosure as either non-performing or impaired.

At September 30, 2008, no concentration of loans to commercial borrowers engaged in similar activities exceeded 10% of total loans. The largest industry concentration at September 30, 2008 was approximately 5.7% of loans to the hospitality industry (hotels, motels, inns, etc.). For more information regarding the Bank s concentration of loans collateralized by real estate, please refer to the discussion under Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2007 entitled We have a high concentration of loans secured by real estate and a downturn in the real estate market, for any reason, may increase our credit losses, which would negatively affect our financial results.

Based on recently enacted regulatory guidelines, the Bank is now required to monitor the commercial investment real estate loan portfolio for: (a) concentrations above 100% of Tier 1 capital and loan loss reserve for construction and land loans and (b) 300% for permanent investor real estate loans. As of September 30, 2008, construction and land loans are $41.1 million or 79.5% of the concentration limit. Commercial real estate loans , including construction and land loans, are $99.6 million or 192.6% of the concentration level.

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

**CONTRACTUAL OBLIGATIONS**

During March 2008, the Bank sold its Route 29 Warrenton branch building and land as part of an exchange of real estate properties. The property the Bank received, also on Route 29 in Warrenton, VA, will be the future site of a larger, more conveniently located branch building. During the time-period of construction of the new branch site, the Bank will rent the existing Route 29 Warrenton branch building for approximately $180,000 on an annualized basis.

As of September 30, 2008, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in Management s Discussion and Analysis in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

**OFF-BALANCE SHEET ARRANGEMENTS**

As of September 30, 2008, 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, 2007.

**CAPITAL**

The Company and the Bank are subject to various regulatory capital requirements administered by banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and discretionary actions by regulators that could have a direct material effect on the Company s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company s and the Bank s capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier I Capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier I Capital to average assets (as defined in the regulations). Management believes, as of September 30, 2008, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

At September 30, 2008 and December 31, 2007, the Company exceeded its regulatory capital ratios, as set forth in the following table:

**RISK BASED CAPITAL RATIOS**
**(Dollars in Thousands)**

| | September 30, 2008 | December 31, 2007 |
|---|---|---|
| Tier 1 Capital: | | |
| Shareholders Equity | $ 40,591 | $ 41,828 |
| Plus: Unrealized loss on securities available for sale/FAS 158 and EITF 06-4 | 2,965 | 773 |
| Less: Intangible assets, net | | (103) |
| Plus: Company-obligated madatorily redeemable capital securities | 4,000 | 4,000 |
| Total Tier 1 Capital | 47,556 | 46,498 |
| Tier 2 Capital: | | |
| Allowable Allowance for Loan Losses | 4,684 | 4,185 |
| Total Capital: | 52,240 | 50,683 |

| | | |
|---|---|---|
| Risk Weighted Assets: | $ 397,755 | $ 390,597 |
| | | |
| Regulatory Capital Ratios: | | |
| Leverage Ratio | 9.38% | 9.49% |
| Tier 1 to Risk Weighted Assets | 11.96% | 11.90% |
| Total Capital to Risk Weighted Assets | 13.13% | 12.98% |

**CAPITAL RESOURCES AND LIQUIDITY**

Shareholders equity totaled $40.6 million at September 30, 2008 compared with $41.8 million at December 31, 2007 and $40.1 million (as restated) at September 30, 2007. The amount of equity reflects management s desire to increase shareholders return on equity while maintaining a strong capital base. The Company initiated an open market stock buyback program in 1998, through which it repurchased 7,332 and 27,370 shares of stock during the first nine months of 2008 and 2007, respectively.

Accumulated other comprehensive income/loss decreased to an unrealized loss net of tax benefit of $3.0 million at September 30, 2008 compared with $773,000 at December 31, 2007. The decline in the accumulated other comprehensive loss was attributable to the decrease in the unrealized loss on investment securities held available for sale.

As discussed above under Company-obligated Mandatorily Redeemable Capital Securities of Subsidiary Trust , in 2002 and 2006, the Company established subsidiary trusts that issued $4.0 million and $4.0 million of capital securities, respectively, as part of two separate pooled trust preferred security offerings with other financial institutions. During 2007, the Company repaid the $4.0 million issued in 2002. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve s capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital. As discussed above under Capital, banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios. As of September 30, 2008, the appropriate regulatory authorities have categorized the Company and the Bank as well capitalized.

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

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled $14.9 million at September 30, 2008 compared with $19.6 million at December 31, 2007. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available of sale, of which approximately $5.8 million was unpledged and readily salable at September 30, 2008. Futhermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately $111.0 million at September 30, 2008 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with various commercial banks totaling approximately $73.9 million. At September 30, 2008, $45.0 million of the FHLB of Atlanta line of credit and none of federal funds purchased lines of credit were in use.

On April 2, 2008, the FHLB of Atlanta informed the Bank that, in light of continued turmoil in mortgage and credit markets, it would increase the discount applied to residential first mortgage collateral from 20% to 25% effective May 1, 2008. On September 22, 2008, the FHLB of Atlanta completed their on-site review of the Bank s individual loans serving as collateral. As result of this increase in required collateralization and the review of actual collateral, the Bank s line of credit with the FHLB of Atlanta totaled approximately $111.0 million on September 30, 2008 as compared with $136.2 million at December 31, 2007. The Bank does not consider this change in collateral requirements by the FHLB of Atlanta to materially impact the Bank s liquidity.

Management is not aware of any market or institutional trends, events or uncertainties that are expected to have a material effect on the liquidity, capital resources or operation of the Company or the Bank. Nor is management aware of any current recommendations by regulatory authorities that would have a material effect on liquidity, capital resources or operations.

The following table sets forth information relating to the Company s sources of liquidity and the outstanding commitments for use of liquidity at September 30, 2008 and December 31, 2007. The liquidity coverage ratio is derived by dividing the total sources of liquidity by the outstanding commitments for use of liquidity.

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

| | September 30, 2008 | | | December 31, 2007 | | |
|---|---|---|---|---|---|---|
| | **Total** | **In Use** | **Available** | **Total** | **In Use** | **Available** |
| Sources: | | | | | | |
| Federal funds borrowing lines of credit | $ 73,873 | $ | $ 73,873 | $ 52,036 | $ | $ 52,036 |
| Federal Home Loan Bank advances | 110,997 | 45,000 | 65,997 | 136,159 | 35,000 | 101,159 |
| Federal funds sold | | | | | | 2,020 |
| Securities, available for sale and unpledged at fair value | | | 5,805 | | | 23,632 |
| Total short-term funding sources | | | $ 145,675 | | | $ 178,847 |
| Uses: | | | | | | |
| Unfunded loan commitments and lending lines of credit | | | $ 68,063 | | | $ 72,503 |
| Letters of credit | | | 6,254 | | | 6,749 |
| Total potential short-term funding uses | | | $ 74,317 | | | $ 79,252 |
| Ratio of short-term funding sources to potential short-term funding uses | | | 196.0% | | | 225.7% |

In addition to the outstanding commitments for use of liquidity displayed in the table above, the Bank will be utilizing approximately $5.0 million over the next twelve to thirty-nine months to build new branch offices in Haymarket and Bristow, as well as move and expand its ViewTree Warrenton branch office.

**IMPACT OF INFLATION AND CHANGING PRICES**

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

**CHANGES IN ACCOUNTING PRINCIPLES**

In September 2006, the Emerging Issues Task Force ( EITF ) issued EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. This consensus concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with SFAS 106 (if, in substance, a postretirement benefit plan exists) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007, with early application permitted. The effect that EITF 06-4 had on the Company s consolidated financial statement of condition for September 30, 2008 was a reduction in retained earnings of $12,000 and an increase in accrued benefit liabilities of $19,000.

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

**FAIR VALUE MEASUREMENTS**

SFAS No. 157, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

| | |
|---|---|
| Level 1 | inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. |
| Level 2 | inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. |
| Level 3 | inputs to the valuation methodology are unobservable and significant to the fair value measurement. |

Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

<u>Securities</u>

Where quoted prices are available in an active market, securities are classified within level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy. At September 30, 2008, all of the Company s securities are considered to be Level 1 or Level 2 securities.

<u>Loans held for sale</u>

Loans held for sale which is required to be measured in a lower of cost or fair value. Under SFAS No. 157, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. At September 30, 2008, the Company did not have any loans held for sale.

<u>Impaired loans</u>

SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, including impaired loans measured at an observable market price (if available), or at the fair value of the loan s collateral (if the loan is collateral dependent). Fair value of the loan s collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

<u>Other Real Estate Owned</u>

Certain assets such as other real estate owned are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

**RECENT ACCOUNTING PROUNCEMENTS**

***Recent Accounting Pronouncements***

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141(R), Business Combinations ( SFAS 141(R) ). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes the criteria for how an acquiring entity in a business combination recognizes the assets acquired and liabilities assumed in the transaction; establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. Acquisition related costs including finder s fees, advisory, legal, accounting valuation and other professional and consulting fees are required to be expensed as incurred. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008 and early implementation is not permitted. The Company does not expect the implementation to have a material impact on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No.160, Noncontrolling Interests in Consolidated Financial Statements ( SFAS 160 ). SFAS 160 requires the Bank (Company) to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ( SFAS 161 ). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, The Hierarchy of Generally Accepted Accounting Principles ( SFAS 162 ). This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS 162 becomes effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411. The Company does not expect the implementation of SFAS 162 to have a material impact on its consolidated financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) No. 157-2, Effective Date of FASB Statement No. 157 ( FSP 157-2 ). FSP FAS 157-2 delays the effective date of SFAS 157, Fair Value Measurements, for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the FASB and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157. FSP 157-2 defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for items within the scope of this FSP. Examples of items to which the deferral would and would not apply are listed in the FSP. The Company does not expect the implementation of FSP 157-2 to have a material impact on its consolidated financial statements.

In October 2008, the FASB issued FSP 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active ( FSP 157-3 ). FSP 157-3 clarifies the application of SFAS 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP was effective upon issuance, including prior periods for which financial statements have not been issued.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

There have been no material changes to the quantitative and qualitative disclosures made in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

**ITEM 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures**

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

As of September 30, 2008, management has assessed the effectiveness of the internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the assessment, management determined that it maintained effective internal control over the financial reporting as of September 30, 2008, based on those criteria, and the Company s Chief Executive Officer and Chief Financial Officer can provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America.

Smith Elliott Kearns & Company, LLC, the independent registered public accounting firm that audited the Company s consolidated financial statements included in the Company s Annual Report on 10-K for the year ended December 31, 2007, has issued an attestation report on the effectiveness of Management s internal control over reporting as of December 31, 2007. The report, which states an unqualified opinion on the effectiveness of Management s internal control over financial reporting as of December 31, 2007, is incorporated for reference in the Company s Annual Report on 10-K for the year ended December 31, 2007 in Item 8 under the heading Report of Independent Registered Public Accounting Firm.

No changes were made in management s internal control over financial reporting during the quarter ended September 30, 2008 that have materially affected, or that are reasonably likely to materially affect, management s internal control over financial reporting.

**PART II**

**ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

There have been no material changes to the risk factors faced by the Company from those disclosed in Company s Annual Report on Form 10-K for the year ended December 31, 2007.

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

**Issuer Purchases of Equity Securities**

| | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publically Announced Plan (1) | Maximum Number of Shares that May Yet Be Purchased Under the Plan (1) |
|---|---|---|---|---|
| July 1 31, 2008 | 1,451 | $ 16.21 | 1,451 | 206,497 |
| August 1 31, 2008 | 637 | $ 16.72 | 637 | 205,860 |
| September 1 30, 2008 | 951 | $ 16.55 | 951 | 204,909 |
| **Total** | 3,039 | $ 16.42 | 3,039 | |

(1) In September 1998, the Company announced an open market buyback program for its common stock. Annually, the Board resets the amount of shares authorized to be repurchased during the year under the buyback program. On January 17, 2008, the Board authorized the Company to repurchase up to 212,241 shares (6% of the shares of common stock outstanding on January 1, 2008) beginning January 1, 2008 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**

None

**ITEM 5. OTHER INFORMATION**

None

**ITEM 6. EXHIBITS**

| Exhibit Number | Exhibit Description |
|---|---|
| 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 | Bylaws of Fauquier Bankshares, Inc., as amended and restated, incorporated by reference to Exhibit 3.2 to Form 8-K filed November 15, 2007. |
| 11 | Refer to Part I, Item 1, Note 6 to the Consolidated Financial Statements. |
| 31.1 | Certification of CEO pursuant to Rule 13a-14(a). |
| 31.2 | Certification of CFO pursuant to Rule 13a-14(a). |
| 32.1 | Certification of CEO pursuant to 18 U.S.C. Section 1350. |
| 32.2 | Certification of CFO pursuant to 18 U.S.C. Section 1350. |

SIGNATURES

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

FAUQUIER BANKSHARES, INC.
(Registrant)

/s/ Randy K. Ferrell
Randy K. Ferrell
President & Chief Executive Officer
Dated: November 6, 2008

/s/ Eric P. Graap
Eric P. Graap
Executive Vice President & Chief Financial Officer
Dated: November 6, 2008