

FAUQUIER BANKSHARES, INC.

Form 10-Q

August 14, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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

or

For the transition period from _____ to _____

Commission File No.: 000-25805

Fauquier Bankshares, Inc.

(Exact name of registrant as specified in its charter)

10 Courthouse Square, Warrenton, Virginia 20186

(Address of principal executive offices) (Zip Code)

(540) 347-2700

(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

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

Yes ☐ No ☐

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

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

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

Yes ☐ No ☒

The registrant had 3,730,877 shares of common stock outstanding as of August 8, 2014.

FAUQUIER BANKSHARES, INC.
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Part I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Balance Sheets

	June 30, 2014 (Unaudited)	December 31, 2013 (Audited)
(In thousands, except share and per share data)		
Assets		
Cash and due from banks	\$ 5,168	\$ 6,120
Interest-bearing deposits in other banks	53,697	64,997
Federal funds sold	12	9
Securities available for sale	57,742	53,571
Restricted investments	1,294	1,462
Loans	443,305	451,377
Allowance for loan losses	(6,753)	(6,667)
Net loans	436,552	444,710
Bank premises and equipment, net	20,066	15,373
Accrued interest receivable	1,544	1,568
Other real estate owned, net of allowance	1,406	4,085
Bank-owned life insurance	12,624	12,433
Other assets	10,669	11,446
Total assets	\$ 600,774	\$ 615,774
Liabilities		
Deposits:		
Noninterest-bearing	\$ 89,798	\$ 88,423
Interest-bearing:		
Checking	211,495	222,507
Savings and money market accounts	124,766	120,457
Time deposits	96,691	108,817
Total interest-bearing	432,952	451,781
Total deposits	522,750	540,204
Federal Home Loan Bank advances	13,107	13,139
Company-obligated mandatorily redeemable capital securities	4,124	4,124
Other liabilities	7,289	7,080
Total liabilities	547,270	564,547
Shareholders' Equity		
Common stock, par value, \$3.13; authorized 8,000,000 shares; issued and outstanding: 2014: 3,730,877 shares including 34,965 non-vested shares; 2013: 3,713,342 shares including 34,109 non-vested shares	11,568	11,516
Retained earnings	42,115	40,652
Accumulated other comprehensive (loss), net	(179)	(941)
Total shareholders' equity	53,504	51,227
Total liabilities and shareholders' equity	\$ 600,774	\$ 615,774

See accompanying Notes to Consolidated Financial Statements.

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Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)
For the Three Months Ended June 30, 2014 and 2013

(In thousands, except per share data)

	2014	2013
Interest Income		
Interest and fees on loans	\$5,026	\$5,409
Interest and dividends on securities available for sale:		
Taxable interest income	333	221
Interest income exempt from federal income taxes	62	62
Dividends	15	16
Interest on deposits in other banks	43	40
Total interest income	5,479	5,748
Interest Expense		
Interest on deposits	526	579
Interest on Federal Home Loan Bank advances	81	195
Distribution on capital securities of subsidiary trusts	50	50
Total interest expense	657	824
Net interest income	4,822	4,924
Provision for loan losses	-	800
Net interest income after provision for loan losses	4,822	4,124
Other Income		
Trust and estate income	452	385
Brokerage income	83	110
Service charges on deposit accounts	660	743
Other service charges, commissions and income	503	501
Total other income	1,698	1,739
Other Expenses		
Salaries and benefits	2,532	2,417
Occupancy expense of premises	532	475
Furniture and equipment	236	261
Marketing expense	142	150
Legal, audit and consulting expense	138	333
Data processing expense	345	326
Federal Deposit Insurance Corporation expense	82	132
Loss on sale or impairment and expense of other real estate owned, net	11	8
Other operating expenses	833	724
Total other expenses	4,851	4,826
Income before income taxes	1,669	1,037
Income tax expense	430	233

Net Income	\$1,239	\$804
Earnings per Share, basic	\$0.33	\$0.22
Earnings per Share, assuming dilution	\$0.33	\$0.22
Dividends per Share	\$0.12	\$0.12

See accompanying Notes to Consolidated Financial Statements.

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

For the Six Months June 30, 2014 and 2013

(In thousands, except

per share data)

	2014	2013
Interest Income		
Interest and fees on loans	\$ 10,140	\$ 10,809
Interest and dividends on securities available for sale:		
Taxable interest income	600	416
Interest income exempt from federal income taxes	123	123
Dividends	43	37
Interest on deposits in other banks	81	84
Total interest income	10,987	11,469
Interest Expense		
Interest on deposits	1,047	1,163
Interest on Federal Home Loan Bank advances	162	440
Distribution on capital securities of subsidiary trusts	99	99
Total interest expense	1,308	1,702
Net interest income	9,679	9,767
Provision for loan losses	-	967
Net interest income after provision for loan losses	9,679	8,800
Other Income		
Trust and estate income	876	723
Brokerage income	160	243
Service charges on deposit accounts	1,266	1,327
	818	886

Other service charges, commissions and income		
Total other income	3,120	3,179
Other Expenses		
Salaries and benefits	5,127	4,812
Occupancy expense of premises	1,105	960
Furniture and equipment	536	528
Marketing expense	283	290
Legal, audit and consulting expense	397	638
Data processing expense	705	647
Federal Deposit Insurance Corporation expense	185	268
Loss (gain) on sale or impairment and expense of other real estate owned, net	(103)	9
Other operating expenses	1,599	1,515
Total other expenses	9,834	9,667
Income before income taxes	2,965	2,312
Income tax expense	733	546
Net Income	\$ 2,232	\$ 1,766
Earnings per Share, basic	\$ 0.60	\$ 0.48
Earnings per Share, assuming dilution	\$ 0.60	\$ 0.47
Dividends per Share	\$ 0.24	\$ 0.24
See accompanying Notes to Consolidated Financial Statements.		

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Comprehensive Income
(Unaudited)
For the Three Months Ended June 30, 2014 and 2013

(In thousands)	2014	2013
Net Income	\$1,239	\$804
Other comprehensive income, net of tax:		
Interest rate swap, net of tax effect of \$15 in 2014 and \$(69) in 2013	(30)	132
Change in fair value of securities available for sale net of tax effect of \$(76) in 2014 and \$327 in 2013	147	(633)
Total other comprehensive income (loss), net of tax effect of \$(61) in 2014 and \$258 in 2013	117	(501)
Comprehensive Income	\$1,356	\$303

For the Six Months Ended June 30, 2014 and 2013

(In thousands)	2014	2013
Net Income	\$2,232	\$1,766
Other comprehensive income (loss), net of tax:		
Interest rate swap, net of tax effect of \$26 in 2014 and \$(86) in 2013	(51)	166
Change in fair value of securities available for sale net of tax effect of \$(419) in 2014 and \$392 in 2013	813	(760)
Total other comprehensive income (loss), net of tax effect of \$(393) in 2014 and \$306 in 2013	762	(594)
Comprehensive Income	\$2,994	\$1,172

See accompanying Notes to Consolidated Financial Statements

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
(Unaudited)
For the Six Months Ended June 30, 2014 and 2013

	Common	Retained	Accumulated Other Comprehensive	Total
(In thousands)	Stock	Earnings	Income (Loss)	
Balance, December 31, 2012	\$ 11,467	\$ 37,993	\$ (1,712)	\$ 47,748
Net income		1,766		1,766
Other comprehensive (loss) net of tax effect of \$306			(594)	(594)
Cash dividends (\$.24 per share)		(891)		(891)
Amortization of unearned compensation, restricted stock awards		75		75
Issuance of common stock – non-vested shares (9,784 shares)	31	(31)		-
Issuance of common stock - vested shares (5,712 shares)	18	50		68
Tax effect of restricted stock grant		(69)		(69)
Balance, June 30, 2013	\$ 11,516	\$ 38,893	\$ (2,306)	\$ 48,103
Balance, December 31, 2013	\$ 11,516	\$ 40,652	\$ (941)	\$ 51,227
Net income		2,232		2,232
Other comprehensive income net of tax effect of \$(393)			762	762
Cash dividends (\$.24 per share)		(895)		(895)
Amortization of unearned compensation, restricted stock awards		74		74
Issuance of common stock – non-vested shares (10,570 shares)	30	(30)		-
Issuance of common stock - vested shares (6,965 shares)	22	82		104
Balance, June 30, 2014	\$ 11,568	\$ 42,115	\$ (179)	\$ 53,504

See accompanying Notes to Consolidated Financial Statements

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)
For the Six Months Ended June 30, 2014 and 2013

(In thousands)	2014	2013
Cash Flows from Operating Activities		
Net income	\$2,232	\$1,766
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	583	557
Loss on disposal of obsolete assets	-	11
Provision for loan losses	-	967
Gain on sale of other real estate owned	(130)	-
(Gain) loss on interest rate swaps	33	(37)
Amortization of security premiums, net	23	42
Amortization of unearned compensation, net of forfeiture	132	117
Tax effect of vested stock grant	-	69
Changes in assets and liabilities:		
(Increase) decrease in other assets	160	(332)
Increase (decrease) in other liabilities	(12)	380
Net cash provided by operating activities	3,021	3,540
Cash Flows from Investing Activities		
Proceeds from maturities, calls and principal payments of securities available for sale	4,996	10,885
Purchase of securities available for sale	(7,960)	(12,592)
Purchase of premises and equipment	(5,277)	(780)
Redemptions restricted securities	168	876
Net decrease in loans	8,271	7,794
Proceeds from sale of other real estate owned	2,809	-
Net cash provided by investing activities	3,007	6,183
Cash Flows from Financing Activities		
Net increase (decrease) in demand deposits, NOW accounts and savings accounts	(5,328)	6,315
Net (decrease) in certificates of deposit	(12,126)	(2,120)
Decrease in FHLB advances	(32)	(15,030)
Cash dividends paid on common stock	(895)	(891)
Issuance of common stock	104	68
Net cash (used in) financing activities	(18,277)	(11,658)
(Decrease) in cash and cash equivalents	(12,249)	(1,935)
Cash and Cash Equivalents		
Beginning	71,126	64,435
Ending	\$58,877	\$62,500
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$1,312	\$1,746

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Income taxes	\$178	\$-
Supplemental Disclosures of Noncash Investing Activities		
Unrealized gain (loss) on securities available for sale, net of tax effect	\$813	\$(760)
Unrealized gain (loss) on interest rate swap, net of taxes	\$(51	) \$166

See accompanying Notes to Consolidated Financial Statements.

FAUQUIER BANKSHARES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. General

The consolidated financial statements include the accounts of Fauquier Bankshares, Inc. ("the Company") and its wholly-owned subsidiaries: The Fauquier Bank ("the Bank") and Fauquier Statutory Trust II; and the Bank's wholly-owned subsidiary, Fauquier Bank Services, Inc. In consolidation, significant intercompany financial balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial positions as of June 30, 2014 and December 31, 2013 and the results of operations for the three and six months ended June 30, 2014 and 2013. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's 2013 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the "SEC").

The results of operations for the six months ended June 30, 2014 are not necessarily indicative of the results expected for the full year or any other interim period.

Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-01, "Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company is currently assessing the impact that ASU 2014-01 will have on its consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, "Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU clarify that an in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements.

In April 2014, the FASB issued ASU 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." The amendments in this ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results and include disposals of a major geographic area, a major line of business, or a major equity method investment. The new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. Additionally, the new guidance requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in the ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-08 to have a material impact on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606". This ASU applies to any entity using generally accepted accounting principles in the United States ("GAAP") that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the revenue recognition requirements in Topic 605, "Revenue Recognition", most industry-specific guidance, and some cost guidance included in Subtopic 605-35, "Revenue Recognition—Construction-Type and Production-Type Contracts". The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2014-09 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU 2014-10, "Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation". The amendments in this ASU remove all incremental financial reporting requirements from GAAP for development stage entities, including the removal of Topic 915, "Development Stage Entities", from the FASB Accounting Standards Codification. In addition, this ASU adds an example disclosure and removes an exception provided to development stage entities in Topic 810, "Consolidation", for determining whether an entity is a variable interest entity. The presentation and disclosure requirements in Topic 915 will no longer be required for the first annual period beginning after December 15, 2014. The revised consolidation standards are effective for annual periods beginning after December 15, 2015. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-10 to have a material impact on its consolidated financial statements.

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

In June 2014, the FASB issued ASU No. 2014-12, "Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period". The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in "Compensation – Stock Compensation (Topic 718)", should be applied to account for these types of awards. The amendments in this ASU are

effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company is currently assessing the impact that ASU 2014-12 will have on its consolidated financial statements.

Note 2. Securities

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

	June 30, 2014			
	Amortized	Gross Unrealized	Gross Unrealized	Fair
(In thousands)	Cost	Gains	(Losses)	Value
Obligations of U.S. Government corporations and agencies	\$47,096	\$ 430	\$ (314)	) \$47,212
Obligations of states and political subdivisions	6,778	397	-	) 7,175
Corporate bonds	3,561	6	(572)	) 2,995
Mutual funds	358	2	-	) 360
	\$57,793	\$ 835	\$ (886)	) \$57,742

	December 31, 2013			
	Amortized	Gross Unrealized	Gross Unrealized	Fair
(In thousands)	Cost	Gains	(Losses)	Value
Obligations of U.S. Government corporations and agencies	\$44,193	\$ 287	\$ (543)	) \$43,937
Obligations of states and political subdivisions	6,781	261	(7)	) 7,035
Corporate bonds	3,524	-	(1,274)	) 2,250
Mutual funds	354	-	(5)	) 349
	\$54,852	\$ 548	\$ (1,829)	) \$53,571

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

	June 30, 2014	
	Amortized	Fair
(In thousands)	Cost	Value
Due in one year or less	\$2,238	\$2,248
Due after one year through five years	9,155	9,143
Due after five years through ten years	12,578	13,015
Due after ten years	33,464	32,976
Equity securities	358	360
	\$57,793	\$57,742

There were no impairment losses on securities during the three and six months ended June 30, 2014 and 2013.

During the six months ended June 30, 2014, no securities were sold, and three securities totaling a fair value of \$2.6 million were called or matured. Over the same period, eight securities totalling \$8.0 million were purchased.

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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 June 30, 2014 and December 31, 2013, respectively.

(In thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
June 30, 2014						
Obligations of U.S. Government, corporations and agencies	\$6,524	\$ (98)	\$13,983	\$ (216)	\$20,507	\$ (314)
Obligations of states and political subdivisions	-	-	-	-	-	-
Corporate bonds	-	-	2,975	(572)	2,975	(572)
Mutual funds	-	-	-	-	-	-
Total temporary impaired securities	\$6,524	\$ (98)	\$16,958	\$ (788)	\$23,482	\$ (886)
December 31, 2013						
Obligations of U.S. Government, corporations and agencies	\$27,557	\$ (543)	\$-	\$-	\$27,557	\$ (543)
Obligations of states and political subdivisions	1,001	(7)	-	-	1,001	(7)
Corporate bonds	-	-	3,524	(1,274)	3,524	(1,274)
Mutual funds	354	(5)	-	-	354	(5)
Total temporary impaired securities	\$28,912	\$ (555)	\$3,524	\$ (1,274)	\$32,436	\$ (1,829)

The nature of securities which were temporarily impaired for a continuous twelve month period or more at June 30, 2014 consisted of three corporate bonds with a cost basis net of other-than-temporary impairment ("OTTI") totaling \$3.6 million and a temporary loss of approximately \$566,000. Beginning December 31, 2013, the value of these bonds is based on quoted market prices for similar assets. These three corporate bonds are the "Class B" or subordinated "mezzanine" tranche of pooled trust preferred securities. The trust preferred securities are collateralized by the interest and principal payments made on trust preferred capital offerings by a geographically diversified pool of approximately 62 different financial institutions per bond. They have an estimated maturity of 20 years. These bonds could have been called at par on the five year anniversary date of issuance, which has already passed for all three bonds. The bonds reprice every three months at a fixed rate index above the three-month LIBOR. These bonds have sufficient collateralization and cash flow projections to satisfy their valuation based on the cash flow portion of the OTTI test under authoritative accounting guidance as of June 30, 2014. One bond, totaling \$1,222,000 at fair value, is greater than 90 days past due, and classified as a nonperforming corporate bond investment in the nonperforming asset table in Note 3. Two bonds, totaling \$1,773,000 at fair value, are performing and projected to repay the full outstanding interest and principal. They are now classified as performing corporate bond investments. During the quarter ended June 30, 2014, \$104,000 of interest income was received and recorded, of which \$79,000 represented deferred interest from prior periods.

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Additional information regarding each of the pooled trust preferred securities as of June 30, 2014 follows:
(Dollars in thousands)

Cost, net of OTTI loss	Fair Value(1)	Percent of Underlying Collateral Performing	Percent of Underlying Collateral in Deferral	Percent of Underlying Collateral in Default	Estimated incremental defaults required to break yield (2)	Cumulative Amount of OTTI Loss	Cumulative Other Comprehensive Loss, net of tax benefit
\$1,624	\$ 1,180	77.7	% 5.7	% 16.6	% 15.8	% \$ 333	\$ 293
1,351	1,222	73.2	% 18.5	% 8.3	% 3.6	% 649	84
586	593	79.2	% 12.9	% 7.9	% 18.8	% 414	(4)
\$3,561	\$ 2,995					\$ 1,396	\$ 373

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

A break in yield for a given tranche investment means that defaults and/or deferrals have reached such a level that the specific tranche would not receive all of the contractual principal and interest cash flow by its maturity,

(2) resulting in not a temporary shortfall, but an actual loss. This column represents the percentage of additional defaults among the currently performing and deferred collateral that would result in OTTI loss

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

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

(In thousands)

Beginning balance as of December 31, 2013	\$1,433
Add: Amount related to the credit loss for which an other-than- temporary impairment was not previously recognized	-
Add: Increases to the amount related to the credit loss for which an other-than temporary impairment was previously recognized	-
Less: Realized losses for securities sold	-
Less: Securities for which the amount previously recognized in other comprehensive income was recognized in earnings because the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis.	-
Less: Increases in cash flows expected to be collected that are recognized over the remaining life of the security (See FASB ASC 320-10-35-35)	(37)
Ending balance as of June 30, 2014	\$1,396

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$40.5 million and \$37.5 million at June 30, 2014 and December 31, 2013, respectively.

Note 3. Loans and Allowance for Loan Losses

Allowance for Loan Losses and Recorded Investment in Loans Receivable

As of and for the Six Months Ended June 30, 2014									
(In thousands) Allowance for Loan Losses	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Unallocated	Total
Beginning balance at 12/31/2013	\$964	\$2,320	\$412	\$18	\$196	\$1,261	\$1,314	\$182	\$6,667
Charge-offs	(9)	-	-	(4)	(53)	-	-	-	(66)
Recoveries	82	-	65	2	-	2	1	-	152
Provision	(280)	(488)	528	(2)	(8)	311	(235)	174	-
Ending balance at 6/30/2014	\$757	\$1,832	\$1,005	\$14	\$135	\$1,574	\$1,080	\$356	\$6,753
Ending balances individually evaluated for impairment	\$342	\$545	\$905	\$-	\$-	\$521	\$-	\$-	\$2,313
Ending balances collectively evaluated for impairment	\$415	\$1,287	\$100	\$14	\$135	\$1,053	\$1,080	\$356	\$4,440
Loans Receivable Individually evaluated for impairment	\$512	\$4,728	\$3,954	\$-	\$-	\$2,445	\$70		\$11,709
Collectively evaluated for impairment	24,679	164,150	28,659	3,281	24,628	141,744	44,455		431,596
Ending balance at 6/30/2014	\$25,191	\$168,878	\$32,613	\$3,281	\$24,628	\$144,189	\$44,525		\$443,305

As of and for the Year Ended December 31, 2013									
(In thousands) Allowance for Loan Losses	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Unallocated	Total
	\$932	\$1,685	\$402	\$40	\$-	\$1,691	\$1,336	\$172	\$6,258

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Beginning balance at 12/31/2012									
Charge-offs	(257)	(686)	-	(104)	-	(284)	(174)	-	(1,505)
Recoveries	76	-	-	25	-	2	11	-	114
Provision	213	1,321	10	57	196	(148)	141	10	1,800
Ending balance at 12/31/2013	\$964	\$2,320	\$412	\$18	\$196	\$1,261	\$1,314	\$182	\$6,667
Ending balances individually evaluated for impairment	\$211	\$505	\$321	\$-	\$-	\$276	\$-	\$-	\$1,313
Ending balances collectively evaluated for impairment	\$753	\$1,815	\$91	\$18	\$196	\$985	\$1,314	\$182	\$5,354
Loans Receivable Individually evaluated for impairment	\$477	\$4,177	\$3,980	\$-	\$-	\$2,100	\$70		\$10,804
Collectively evaluated for impairment	24,269	172,143	28,827	3,810	27,962	140,156	43,406		440,573
Ending balance at 12/31/2013	\$24,746	\$176,320	\$32,807	\$3,810	\$27,962	\$142,256	\$43,476		\$451,377

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The Company's allowance for loan losses has three basic components: the specific allowance, the general allowance, and the unallocated components. The specific allowance is used to individually allocate an allowance for larger balance, non-homogeneous loans identified as impaired. The general allowance is used for estimating the loss on pools of smaller-balance, homogeneous loans; including 1-4 family mortgage loans, installment loans and other consumer loans. Also, the general allowance is used for the remaining pool of larger balance, non-homogeneous loans which were not identified as impaired. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Credit Quality Indicators

As of June 30, 2014

(In thousands)	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Total
Grade:								
Pass	\$22,554	\$ 154,722	\$ 28,659	\$ 3,274	\$24,628	\$ 131,968	\$39,250	\$405,055
Special mention	598	3,947	-	-	-	2,449	2,612	9,606
Substandard	2,039	10,209	3,954	7	-	9,713	2,663	28,585
Doubtful	\$-	-	-	-	-	59	-	59
Loss	-	-	-	-	-	-	-	-
Total	\$25,191	\$ 168,878	\$ 32,613	\$ 3,281	\$24,628	\$ 144,189	\$44,525	\$443,305

As of December 31, 2013

(In thousands)	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Line of Credit	Total
Grade:								
Pass	\$21,524	\$ 153,940	\$ 28,827	\$ 3,803	\$27,962	\$ 129,677	\$39,654	\$405,387
Special mention	551	9,888	-	-	-	2,282	1,051	13,772
Substandard	2,498	12,492	3,980	7	-	9,623	2,771	31,371
Doubtful	173	-	-	-	-	674	-	847
Loss	-	-	-	-	-	-	-	-
Total	\$24,746	\$ 176,320	\$ 32,807	\$ 3,810	\$27,962	\$ 142,256	\$43,476	\$451,377

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Age Analysis of Past Due Loans Receivable

(In thousands)	As of June 30, 2014					Total Financing Receivables	Carrying Amount > 90 Days and Accruing	Nonaccruals
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current			
Commercial and industrial	\$220	\$28	\$-	\$248	\$24,943	\$ 25,191	\$ -	\$ 361
Commercial real estate	1,779	-	-	1,779	167,099	168,878	-	-
Construction and land	904	3	-	907	31,706	32,613	-	-
Consumer	6	5	1	12	3,269	3,281	1	-
Student (U.S. Government guaranteed)	1,434	1,018	2,949	5,401	19,227	24,628	2,949	-
Residential real estate	954	1,412	744	3,110	141,079	144,189	-	1,849
Home equity line of credit	67	66	-	133	44,392	44,525	-	-
Total	\$5,364	\$2,532	\$3,694	\$11,590	\$431,715	\$ 443,305	\$ 2,950	\$ 2,210

(In thousands)	As of December 31, 2013					Total Financing Receivables	Carrying Amount > 90 Days and Accruing	Nonaccruals
	30-59	60-89	90	Total Past Due	Current			
	Days	Days	Days					
	Past	Past	More Past					
Commercial and industrial	\$409	\$69	\$161	\$639	\$24,107	\$ 24,746	\$ -	\$ 379
Commercial real estate	426	-	442	868	175,452	176,320	-	442
Construction and land	5	-	338	343	32,464	32,807	338	-
Consumer	18	-	-	18	3,792	3,810	-	-
Student (U.S. Government guaranteed)	2,851	761	7,917	11,529	16,433	27,962	7,917	-
Residential real estate	-	738	780	1,518	140,738	142,256	168	1,363
Home equity line of credit	497	-	-	497	42,979	43,476	-	-
Total	\$4,206	\$1,568	\$9,638	\$15,412	\$435,965	\$ 451,377	\$ 8,423	\$ 2,184

The Company began purchasing rehabilitated student loans under the Federal Rehabilitated Student Loan Program during the quarter ended December 31, 2012. The repayment of both principal and accrued interest are 98% guaranteed by the U.S. Department of Education. At June 30, 2014, \$2.9 million of the student loans were 90 days or more past due and still accruing.

Impaired Loans Receivable

(In thousands)	June 30, 2014			Average Recorded Investment	Interest Income Recognized
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
With no specific allowance recorded:					
Commercial and industrial	\$34	\$56	\$ -	\$ 40	\$ -
Commercial real estate	1,900	1,900	-	1,900	48
Construction and land	1,184	1,184	-	1,188	30
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	1,322	1,444	-	1,338	15
Home equity line of credit	70	70	-	70	1
Consumer	-	-	-	-	-
With an allowance recorded:					
Commercial and industrial	\$478	\$513	\$ 342	\$ 478	\$ 5
Commercial real estate	2,828	2,828	545	2,828	80
Construction and land	2,770	2,770	905	2,778	63
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	1,123	1,123	521	1,148	15
Home equity line of credit	-	-	-	-	-
Consumer	-	-	-	-	-
Total:					
Commercial and industrial	\$512	\$569	\$ 342	\$ 518	\$ 5
Commercial real estate	4,728	4,728	545	4,728	128
Construction and land	3,954	3,954	905	3,966	93
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	2,445	2,567	521	2,486	30
Home equity line of credit	70	70	-	70	1
Consumer	-	-	-	-	-
Total	\$11,709	\$11,888	\$ 2,313	\$ 11,768	\$ 257
December 31, 2013					
(In thousands)	December 31, 2013			Average Recorded Investment	Interest Income Recognized
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
With no specific allowance recorded:					
Commercial and industrial	\$156	\$176	\$ -	\$ 175	\$ 4
Commercial real estate	2,182	2,182	-	2,197	88
Construction and land	1,984	1,984	-	2,011	99
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	1,188	1,286	-	1,236	17
Home equity line of credit	70	70	-	69	-
Consumer	-	-	-	-	-
With an allowance recorded:					
Commercial and industrial	\$321	\$365	\$ 211	\$ 340	\$ 2
Commercial real estate	1,995	2,009	505	2,002	92

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Construction and land	1,996	1,996	321	1,998	88
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	912	912	276	940	16
Home equity line of credit	-	-	-	-	-
Consumer	-	-	-	-	-
Total:					
Commercial and industrial	\$477	\$541	\$211	\$515	\$6
Commercial real estate	4,177	4,191	505	4,199	180
Construction and land	3,980	3,980	321	4,009	187
Student (U.S. Government guaranteed)	-	-	-	-	-
Residential real estate	2,100	2,198	276	2,176	33
Home equity line of credit	70	70	-	69	-
Consumer	-	-	-	-	-
Total	\$10,804	\$10,980	\$1,313	\$10,968	\$406

Authoritative accounting guidance requires that the impairment of loans that have been separately identified for evaluation is to be measured based on the present value of expected future cash flows or, alternatively, the observable market price of the loans or the fair value of the collateral. However, for those loans that are collateral dependent (that is, if repayment of those loans is expected to be provided solely by the underlying collateral) and for which management has determined foreclosure is probable, the measure of impairment is to be based on the net realizable value of the collateral. Authoritative accounting guidance also requires certain disclosures about investments in impaired loans and the allowance for loan losses and interest income recognized on loans.

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

At June 30, 2014, there were \$7.0 million of commercial loans classified as substandard which were deemed not to be impaired because borrowers continue to abide by the terms of their original loan agreements and are substandard based on their industry or changes in their cash flow that have not yet resulted in past dues. Impaired loans totaled \$11.7 million at June 30, 2014, representing an increase of \$905,000 from December 31, 2013. The change was due primarily to the addition of seven loans totaling \$2.3 million, which were partially offset by loans that were either paid or charged off. Approximately \$11.2 million of loans classified as impaired at June 30, 2014 were collateralized by commercial buildings, residential real estate, or land.

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

Troubled Debt Restructurings

	Three Months Ended June 30, 2014			Three Months Ended June 30, 2013		
	Pre-Modification Number Outstanding of Recorded Commitment	Post-Modification Outstanding Recorded Investment		Pre-Modification Number Outstanding of Recorded Commitment	Post-Modification Outstanding Recorded Investment	
(Dollars in thousands)						
Troubled Debt Restructurings						
Commercial and industrial	2	\$ 198	\$ 198	-	\$ -	\$ -
Commercial real estate	-	-	-	-	-	-
Construction and land	-	-	-	1	808	808
Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	-	-	-	1	300	300
Home equity line of credit	-	-	-	-	-	-
Troubled Debt Restructurings That Subsequently Defaulted						-
Commercial and industrial	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Construction and land	-	-	-	-	-	-

Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-
Home equity line of credit	-	-	-	-	-	-

	Six Months Ended June 30, 2014			Six Months Ended June 30, 2013		
	Pre-Modification	Post-Modification		Pre-Modification	Post-Modification	
(Dollars in thousands)	Number of Outstanding Recorded Investments	Number of Outstanding Recorded Investments		Number of Outstanding Recorded Investments	Number of Outstanding Recorded Investments	
Troubled Debt Restructurings						
Commercial and industrial	2	\$ 198	\$ 198	-	\$ -	\$ -
Commercial real estate	-	-	-	2	2,010	2,010
Construction and land	-	-	-	1	808	808
Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	-	-	-	1	300	300
Home equity line of credit	-	-	-	-	-	-
Troubled Debt Restructurings That Subsequently Defaulted						
Commercial and industrial	-	-	-	1	237	237
Commercial real estate	-	-	-	-	-	-
Construction and land	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Student	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-
Home equity line of credit	-	-	-	-	-	-

During the quarter ended June 30, 2014, there were two loans modified and deemed Troubled Debt Restructurings ("TDRs"). At the end of the quarter, 15 TDRs, totaling \$9.5 million, were in the portfolio. Eleven of the loans, totaling \$8.3 million, were on accrual status and performing in accordance with the modified terms. The remaining four loans, totaling \$1.2 million, remained in nonaccrual status due to irregular payments. Appropriate specific reserves have been established. Restructured loans are included in the specific reserve calculation in the allowance for loan losses and are included in impaired loans.

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

	June 30, 2014	December 31, 2013	June 30, 2013
(Dollars in thousands)			
Non-accrual loans	\$2,210	\$ 2,184	\$6,698
Other real estate owned	1,406	4,085	1,406
Non-performing corporate bond investments, at fair value	1,222	1,300	96
Total non-performing assets	4,838	7,569	8,200
Restructured loans still accruing	8,343	8,613	8,484
Student loans (U.S. Government guaranteed) past due 90 days or more and still accruing	2,949	7,917	3,220
Loans past due 90 or more days and still accruing	1	506	355
Total non-performing and other risk assets	\$16,131	\$ 24,605	\$20,259
Allowance for loan losses to total loans	1.52 %	1.48 %	1.54 %
Non-accrual loans to total loans	0.50 %	0.48 %	1.51 %
Allowance for loan losses to non-accrual loans	305.57 %	305.27 %	102.06 %
Total non-accrual loans and restructured loans still accruing to total loans	2.38 %	2.39 %	3.43 %
Allowance for loan losses to non-accrual loans and restructured loans still accruing	63.99 %	61.75 %	45.03 %
Total non-performing assets to total assets	0.81 %	1.23 %	1.39 %

Restructured loans on non-accrual status are included with non-accrual loans and not with restructured loans in the above table.

Note 4. Company-Obligated Mandatorily Redeemable Capital Securities

On September 21, 2006, the Company's wholly-owned Connecticut statutory business trust privately issued \$4.0 million face amount of the trust's Floating Rate Capital Securities in a pooled capital securities offering ("Trust II"). Simultaneously, the trust used the proceeds of that sale to purchase \$4.0 million principal amount of the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. The interest rate on the capital security resets every three months at 1.70% above the then current three month LIBOR. Interest is paid quarterly. Total capital securities at June 30, 2014 and December 31, 2013 were \$4,124,000. The Trust II issuance of capital securities and the respective subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

Note 5. Derivative Instruments and Hedging Activities

GAAP requires that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the date that the derivative contract is entered into, the Company designates the derivative as a hedge of variable cash flows to be paid or received in conjunction with recognized assets or liabilities, as a cash flow or fair value hedge. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is reported in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income. For a derivative treated as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current earnings in interest income. The Company uses interest rate swaps to reduce interest rate risks and to manage net interest income.

The Company formally assesses, both at the hedges' inception, and on an on-going basis, whether derivatives used in hedging transactions have been highly effective in offsetting changes in cash flows of hedged items and whether those derivatives are expected to remain highly effective in subsequent periods. The Company discontinues hedge

accounting when (a) it determines that a derivative is no longer effective in offsetting changes in cash flows of a hedged item; (b) the derivative expires or is sold, terminated or exercised; (c) probability exists that the forecasted transaction will no longer occur; or (d) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all cases in which hedge accounting is discontinued and a derivative remains outstanding, the Company will carry the derivative at fair value in the Consolidated Financial Statements, recognizing changes in fair value in current period income in the consolidated statement of income.

The Company follows GAAP, FASB ASU 815-10-50 "Disclosures about Derivative Instruments and Hedging Activities", which includes the disclosure requirements for derivative instruments and hedging activities to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows.

Interest differentials paid or received under the swap agreements are reflected as adjustments to interest income. These interest rate swap agreements include both cash flow and fair value hedge derivative instruments that qualify for hedge accounting. The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counter party, the risk in these transactions is the cost of replacing the agreements at current market rates.

The Company entered into an interest rate swap agreement on July 1, 2010 to manage the interest rate exposure on its Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. By entering into this agreement, the Company converts a floating rate liability into a fixed rate liability through 2020. Under the terms of the agreement, the Company receives interest quarterly at the rate equivalent to three month LIBOR plus 1.70%, repricing every three months on the same date as the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036, and pays interest expense monthly at the fixed rate of 4.91%. The interest expense on the interest rate swap was \$30,000 for the three months ended June 30, 2014 and 2013. The interest expense on the interest rate swap was \$60,000 and \$59,000 for the six months ended June 30, 2014 and 2013, respectively. The swap is designated as a cash flow hedge and changes in the fair value are recorded as an adjustment through other comprehensive income.

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The Company entered into three swap agreements to manage the interest rate risk related to three commercial loans. The agreements allow the Company to convert fixed rate assets to floating rate assets through 2021 and 2022. The Company receives interest monthly at the rate equivalent to one month LIBOR, plus a spread repricing on the same date as the loans, and pays interest at fixed rates. The interest expense on the interest rate swaps was \$28,000 and \$26,000 for the three months ended June 2014 and 2013, respectively. For the six months ended both June 30, 2014 and 2013 the interest expense was \$54,000, and is recorded in loan interest income. These swaps are designated as fair value hedges and changes in fair value are recorded in current earnings.

Cash collateral held at other banks for these swaps was \$900,000 at June 30, 2014. Collateral posted and received is dependent on the market valuation of the underlying hedges.

The effects of derivative instruments on the Consolidated Financial Statements for June 30, 2014 and December 31, 2013 are as follows:

(In thousands)	June 30, 2014		Estimated	
	Notional Contract Amount	Net Fair Value	Fair Value Balance Sheet Location	Expiration Date
Derivatives designated as hedging instruments				
Interest rate swap-10 year cash flow	\$4,000	\$ (300)	)Liabilities	9/15/2020
Interest rate swap-10 year fair value	2,137	(44)	)Liabilities	8/15/2021
Interest rate swap-10 year fair value	2,015	(43)	)Liabilities	8/15/2021
Interest rate swap-10 year fair value	1,013	36	Other Assets	9/26/2022

	June 30, 2014	
	Amount of Gain (Loss) Recognized in OCI on Derivatives net of tax	Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion) Not applicable
Derivatives in cash flow hedging relationships		
Interest rate swap	\$(51)	\$ -

(In thousands) June 30, 2014

		Gain or (Loss)
	Income Statement	on
Derivatives in fair value hedging relationships	Classification	Swaps
Interest rate swaps	Interest income	\$ (33)

(In thousands)	December 31, 2013			
	Estimated			
Derivatives designated as hedging instruments	Notional/Net Contract Fair Amount Value	Fair Value Balance Sheet Location	Expiration Date	
Interest rate swap-10 year cash flow	\$4,000 \$ (223)	Liabilities	9/15/2020	
Interest rate swap-10 year fair value	2,161 13	Other Assets	8/15/2021	
Interest rate swap-10 year fair value	2,037 11	Other Assets	8/15/2021	
Interest rate swap-10 year fair value	1,025 72	Other Assets	9/26/2022	

	December 31, 2013		
	Amount of Gain (Loss) Recognized in OCI on Derivatives, net of tax	Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion)
Derivatives in cash flow hedging relationships	(Effective Portion)	Income on Derivative (Ineffective Portion)	Derivative (Ineffective Portion)
Interest rate swaps	\$ 214	Not applicable	\$ -

(In thousands)	December 31, 2013	
		Gain or (Loss)
Derivatives in fair value hedging relationships	Income Statement	on
	Classification	Swaps
Interest rate swaps	Interest Income	\$ 51

Note 6. Earnings Per Share

The following table shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of dilutive potential common stock for the periods indicated.

	Three Months Ended June 30, 2014		Three Months Ended June 30, 2013	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,730,877	\$ 0.33	3,713,342	\$ 0.22
Effect of dilutive securities, stock-based awards	17,422		15,622	
Diluted earnings per share	3,748,299	\$ 0.33	3,728,964	\$ 0.22

	Six Months Ended June 30, 2014		Six Months Ended June 30, 2013	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,725,713	\$ 0.60	3,708,219	\$ 0.48
Effect of dilutive securities, stock-based awards	15,914		14,084	
Diluted earnings per share	3,741,627	\$ 0.60	3,722,303	\$ 0.47

Note 7. Stock Based Compensation

Stock Incentive Plan

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

Under the Plan, stock options, stock appreciation rights, non-vested and/or restricted shares, and long-term performance unit awards may be granted to directors and certain employees for purchase of the Company's common stock. The effective date of the Plan is March 19, 2009, the date the Company's Board approved the Plan, and it has a termination date of December 31, 2019. The Company's Board may terminate, suspend or modify the Plan within certain restrictions. The Plan authorizes for issuance 350,000 shares of the Company's common stock. The Plan requires that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant. Such options are generally not exercisable until three years from the date of issuance and generally require continuous employment during the period prior to exercise. The options will expire in no more than ten years after the date of grant. The stock options, stock appreciation rights, restricted shares, and long-term performance unit awards for certain employees are generally subject to vesting requirements and are subject to forfeiture if vesting and other contractual provision requirements are not met. The Company did not grant stock options during the six months ended June 30, 2014 and there were no options outstanding at June 30, 2014.

Restricted Shares

The restricted shares are accounted for using the fair market value of the Company's common stock on the date the restricted shares were awarded. The restricted shares issued to certain officers are subject to a vesting period, whereby, the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded.

Compensation expense for these shares is recognized over the three year period. The restricted share issued to non-employee directors are not subject to a vesting period, and compensation expense is recognized at the date the shares are granted.

The Company has granted awards of non-vested shares to certain officers and vested shares to non-employee directors under the above-described incentive plans: 10,570 shares and 12,470 shares of non-vested restricted stock to executive officers, and 4,050 shares and 5,712 shares of vested restricted stock to non-employee directors on February 20, 2014 and February 21, 2013, respectively. The compensation expense for these non-vested shares is recognized over a period of three years, and was \$38,000 and \$36,000, net of forfeiture, for the three months ended June 30, 2014 and 2013 and \$75,000 for the six months ended both June 30, 2014 and 2013. As of June 30, 2014 there was \$250,000 of total unrecognized compensation cost related to these non-vested shares, which will be recorded in conjunction with the vesting periods over the remaining 30 months. Compensation expense for the non-employee director shares is recognized at the date the shares are granted and during the three months ended June 30, 2014 and 2013, none was recognized. For the six months ended June 30, 2014 and 2013, \$64,000 and \$68,000 was recognized.

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

	Six Months Ended June 30, 2014	
	Shares	Weighted Average Fair Value
Non-vested at January 1, 2014	34,109	\$ 12.65
Granted	14,620	15.70
Vested	(13,764)	14.73
Forfeited	-	
Non-vested at June 30, 2014	34,965	\$ 13.11

The Company granted performance-based stock rights relating to 10,746 and 12,470 shares to certain officers on February 20, 2014, and February 21, 2013, under the Plan. The performance-based stock rights are accounted for using the fair market value of the Company's common stock on the date awarded, and adjusted as the market value of the stock changes. The performance-based stock rights issued to executive officers are subject to a vesting period, whereby the restrictions on the shares lapse on the third year anniversary of the date the shares were awarded. Until vesting, the shares are not issued and not included in shares outstanding. The awards are subject to the Company reaching a predetermined three year performance average on the return on average equity ratio, also as compared to a predetermined peer group of banks. The compensation expense for performance-based stock rights totaled \$31,000 and \$21,000 for the three months ended June 30, 2014 and 2013, respectively. For the six months ended June 30, 2014 and 2013, compensation expense was \$57,000 and \$42,000, respectively.

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

	Six Months Ended June 30, 2014	
	Performance Based Stock Rights (Shares)	Weighted Average Fair Value
Non-vested at January 1, 2014	34,109	\$ 12.65
Granted	10,746	15.69
Vested	(9,714)	14.30
Forfeited	-	
Non-vested at June 30, 2014	35,141	\$ 13.12

Note 8. Employee Benefit Plans

The Company has a defined contribution retirement plan under Internal Revenue Code of 1986 ("Code") Section 401(k) covering employees who have completed three months of service and who are at least 18 years of age. Under the plan, a participant may contribute an amount up to 100% of their covered compensation for the year, not to exceed the dollar limit set by law (Code Section 402(g)). The Company will make an annual matching contribution equal to 100% on the first 1% of compensation deferred and 50% on the next 5% of compensation deferred, for a maximum match of 3.5% of compensation. Beginning in 2010, the Company began making an additional safe harbor contribution equal to 6% of compensation to all eligible participants. The Company's 401(k) expenses for the three months ended June 30, 2014 and 2013 were \$183,000 and \$180,000, respectively. For the six months months ended June 30, 2014, and 2013, 401(k) expenses were \$344,000 and \$341,000, respectively

The Company also maintains a Director Deferred Compensation Plan ("Deferred Compensation Plan"). This plan provides that any non-employee director of the Company or the Bank may elect to defer receipt of all or any portion of his or her compensation as a director. A participating director may elect to have amounts deferred under the Deferred Compensation Plan held in a deferred cash account, which is credited on a quarterly basis with interest equal to the highest rate offered by the Bank at the end of the preceding quarter. Alternatively, a participant may elect to have a deferred stock account in which deferred amounts are treated as if invested in the Company's common stock at the fair market value on the date of deferral. The value of a stock account will increase and decrease based upon the fair market value of an equivalent number of shares of common stock. In addition, the deferred amounts deemed invested in common stock will be credited with dividends on an equivalent number of shares. Amounts considered invested in the Company's common stock are paid, at the election of the director, either in cash or in whole shares of the common stock and cash in lieu of fractional shares. Directors may elect to receive amounts contributed to their respective accounts in one or up to five installments. There are no directors currently participating in the Deferred Compensation Plan.

The Company has a nonqualified deferred compensation plan for a former key employee's retirement, in which the contribution expense is solely funded by the Company. The retirement benefit to be provided is variable based upon the performance of underlying life insurance policy assets. For the three months ended June 30, 2014 and 2013, deferred compensation expense was \$9,000 and \$8,000, respectively. For the six months ended June 30, 2014 and 2013, compensation expense was \$20,000 and \$17,000, respectively.

Concurrent with the establishment of the deferred compensation plan for the former employee, the Company purchased life insurance policies on this employee with the Company named as owner and beneficiary. These life insurance policies are intended to be utilized as a source of funding the plan. Income on these life insurance policies amounted to \$8,000 and \$5,000 for the three months and \$16,000 and \$14,000 for the six months ended June 30, 2014 and 2013, respectively. The Company has recorded other assets of \$1.2 million representing cash surrender value of these policies at both June 30, 2014 and December 31, 2013.

Note 9. Fair Value Measurement

The Company follows ASC 820 "Fair Value Measurement and Disclosures" to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. ASC 820 clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

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

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

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

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

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

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data (Level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any, market activity then the security would fall to the lowest level of the hierarchy (Level 3). The Company's investment portfolio is primarily valued using fair value measurements that are considered to be Level 2. The Company has contracted with a third party portfolio accounting service vendor for valuation of its securities. The vendor's primary source for security valuation is Interactive Data Corporation ("IDC"), which evaluates securities based on market data. IDC utilizes evaluated pricing models that vary by asset class and include available trade, bid, and other market information.

Generally, the methodology includes broker quotes, proprietary modes, vast descriptive terms and conditions databases, as well as extensive quality control programs. The carrying value of restricted Federal Reserve Bank of Richmond, Community Bankers Bank and Federal Home Loan Bank of Atlanta ("FHLB") stock approximates fair value based on the redemption provisions of each entity and are therefore excluded from the following table.

Interest rate swaps: Interest rate swaps are recorded at fair value on a recurring basis. The Company utilizes interest rate swap agreements as part of the management of interest rate risk to modify the repricing characteristics of certain portions of the Company's interest-bearing assets and liabilities. The Company has contracted with a third party to provide valuations for interest rate swaps using standard valuation techniques and therefore classifies such valuation as Level 2. The Company has considered counterparty credit risk in the valuation of its interest rate swap assets and has considered its own credit risk in the valuation of its interest rate swap liabilities.

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2014 and December 31, 2013 by levels within the valuation hierarchy:

	Balance	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)				
Assets at June 30, 2014:				
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	\$47,212	\$ -	\$ 47,212	\$ -
Obligations of states and political subdivisions	7,175	-	7,175	-
Corporate bonds	2,995	-	2,995	-
Mutual funds	360	360	-	-
Total available for sale securities	57,742	360	57,382	-
Interest rate swaps	36	-	36	-
Total assets at fair value	\$57,778	\$ 360	\$ 57,418	\$ -
Liabilities at June 30, 2014:				
Interest rate swaps	\$387	\$ -	\$ 387	\$ -
Total liabilities at fair value	\$387	\$ -	\$ 387	\$ -

Assets at December 31, 2013:

Available for sale securities:

Obligations of U.S. Government corporations and agencies	\$43,937	\$ -	\$ 43,937	\$ -
Obligations of states and political subdivisions	7,035	-	7,035	-
Corporate bonds	2,250	-	2,250	-
Mutual funds	349	349	-	-
Total available-for sale securities	53,571	349	53,222	-
Interest rate swaps	96	-	96	-
Total assets at fair value	\$53,667	\$ 349	\$ 53,318	\$ -

Liabilities at December 31, 2013:

Interest rate swaps	223	-	223	-
Total liabilities at fair value	\$223	\$ -	\$ 223	\$ -

Change in Level 3 Fair Value

There were no Level 3 assets measured at estimated fair value on a recurring basis as of June 30, 2014. The changes in Level 3 assets measured at estimated fair value on a recurring basis during the year ended December 31, 2013 were as follows:

	Total Gains (Losses) Realized/Unrealized				
	Balance	Included in	Transfers	in	Balance
	January	Included	Other	and/or	December
(In thousands)	1, in	Earnings	Income	Level 3	31, 2013
Available for sale securities	\$ 325	\$ 144	\$ 1,781	\$ (2,250)	\$ -

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

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

Impaired Loans: A loan is designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with an impaired loan can be based on either the observable market price of the loan or the fair value of the collateral securing the loan. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. At June 30, 2014, the Company's Level 3 loans for which a reserve has been taken, consisted of four loans totaling \$393,000 secured by business assets and inventory with a reserve of \$298,000, and two loans totaling \$399,000 secured by real estate with a reserve of \$392,000.

Other Real Estate Owned ("OREO"): Foreclosed assets are adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair market value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company considers the OREO as nonrecurring Level 2. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the OREO as nonrecurring Level 3. Total valuation of OREO

property was \$1.4 million and \$4.1 million at June 30, 2014 and December 31, 2013, respectively.

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

Carrying Value at June 30, 2014				
		Quoted Prices in Active Markets		
	Balance as of June 30, 2014	for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets:				
Impaired loans, net	\$4,886	\$ -	\$ 4,784	\$ 102
Other real estate owned, net	1,406	-	1,406	-

Carrying Value at December 31, 2013				
		Quoted Prices in Active Markets		
	Balance as of December 31, 2013	for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets:				
Impaired loans, net	\$3,911	\$ -	\$ 3,748	\$ 163
Other real estate owned, net	4,085	-	4,085	-

The following table displays quantitative information about Level 3 Fair Value Measurements at June 30, 2014.

Quantitative Information about Level 3 Fair Value Measurements				Weighted Average Discount	
(In thousands)	Fair Value	Valuation Technique(s)	Unobservable Input		
Impaired loans	\$102	Appraised values	Age of appraisal, current market conditions, experience within local market, and U.S. Government guarantees	87	%
Total	\$102				

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques.

Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instruments. ASC 820 excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

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

Cash and cash equivalents: The carrying amounts of cash and short-term instruments with a maturity of three months or less approximate fair value. Instruments with maturities of greater than three months are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar instruments.

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

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

Accrued Interest: The carrying amounts of accrued interest approximate fair value.

Life Insurance: The carrying amount of life insurance contracts is assumed to be a reasonable fair value. Life insurance contracts are carried on the balance sheet at their redemption value. This redemption value is based on existing market conditions and therefore represents the fair value of the contract.

Interest Rate Swaps: The fair values are based on quoted market prices or mathematical models using current and historical data.

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

Federal Funds Purchased: The carrying amounts of the Company's federal funds purchased approximate fair value.

Borrowed Funds: The fair values of the Company's FHLB advances and other borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

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

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

At June 30, 2014 and December 31, 2013, the fair values of loan commitments and standby letters of credit were deemed immaterial.

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

	Fair Value Measurements at June 30, 2014				
	Carrying Value as of June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Fair Value as of June 30, 2014
(In thousands)					
Assets					
Cash and short-term investments	\$58,877	\$58,940	\$ -	\$ -	\$58,940
Securities available for sale	57,742	360	57,382	-	57,742
Restricted investments	1,294	-	1,294	-	1,294
Net loans	436,552	-	433,979	102	434,081
Accrued interest receivable	1,544	-	1,544	-	1,544
Interest rate swaps	36	-	36	-	36
BOLI	12,624	-	12,624	-	12,624
Total financial assets	\$568,669	\$59,300	\$506,859	\$102	\$566,261
Liabilities					
Deposits	\$522,750	\$ -	\$523,800	\$ -	\$523,800
Borrowings	13,107	-	13,104	-	13,104
Company obligated mandatorily redeemable capital securities	4,124	-	4,117	-	4,117
Accrued interest payable	215	-	215	-	215
Interest rate swaps	387	-	387	-	387
Total financial liabilities	\$540,583	\$ -	\$541,623	\$ -	\$541,623

	Fair Value Measurements at December 31, 2013				
	Carrying Value as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Fair Value as of December 31, 2013
(In thousands)					
Assets					
Cash and short-term investments	\$71,126	\$71,197	\$ -	\$ -	\$71,197
Securities available for sale	53,571	349	53,222	-	53,571
Restricted investments	1,462	-	1,462	-	1,462
Net Loans	444,710	-	444,587	163	444,750
Accrued interest receivable	1,568	-	1,568	-	1,568
Interest rate swaps	96	-	96	-	96

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BOLI	12,433	-	12,433	-	12,433
Total financial assets	\$584,966	\$71,546	\$513,368	\$163	\$585,077
Liabilities					
Deposits	\$540,204	\$-	\$541,496	\$-	\$541,496
Borrowings	13,139	-	12,833	-	12,833
Company obligated mandatorily redeemable capital securities	4,124	-	4,117	-	4,117
Accrued interest payable	219	-	219	-	219
Interest rate swaps	223	-	223	-	223
Total financial liabilities	\$557,909	\$-	\$558,888	\$-	\$558,888

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

Note 10. Accumulated Other Comprehensive Income

Changes in Accumulated Other Comprehensive Income by Component (1)

(In thousands)	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available for Sale Securities	Supplemental Executive Retirement Plans	Total
Balance December 31, 2013	\$ (147)	\$ (847)	\$ 53	\$(941)
Other comprehensive income (loss) before reclassifications	(51)	813	-	762
Amounts reclassified from accumulated other comprehensive income	-	-	-	-
Net current-period other comprehensive income	(51)	813	-	762
Balance June 30, 2014	\$ (198)	\$ (34)	\$ 53	\$(179)
Balance December 31, 2012	\$ (361)	\$ (1,398)	\$ 47	\$(1,712)
Other comprehensive income (loss) before reclassifications	166	(760)	-	(594)
Amounts reclassified from accumulated other comprehensive income	-	-	-	-
Net current-period other comprehensive income (loss)	166	(760)	-	(594)
Balance June 30, 2013	\$ (195)	\$ (2,158)	\$ 47	\$(2,306)

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

Note 11. Subsequent Event

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

Based on the evaluation, the Company identified one event that required disclosure. On August 5, 2014, the Company realized approximately \$300,000 tax-free death benefit in excess of surrender value related to bank-owned life insurance. The benefit will be reflected in non-interest income in the Company's September 30, 2014 10-Q.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

GENERAL

The Company was incorporated under the laws of the Commonwealth of Virginia on January 13, 1984. The Company is a registered bank holding company and owns all of the voting shares of The Fauquier Bank ("the Bank"). The Company engages in its business through the Bank, a Virginia state-chartered bank that commenced operations in 1902. The Company has no significant operations other than owning the stock of the Bank. The Company had issued and outstanding 3,730,877 shares of common stock, par value \$3.13 per share, held by approximately 369 holders of record at the close of business on June 30, 2014. The Bank has ten full service branch offices located in the Virginia communities of Old Town-Warrenton, Warrenton, Catlett, The Plains, Sudley Road-Manassas, New Baltimore, Bealeton, Bristow, Haymarket, and Gainesville. Additionally, the Bank is projected to open an eleventh branch at 8781 Centreville Road in Manassas, Virginia during the second half of 2014. The executive offices of the Company and the main office of the Bank are located at 10 Courthouse Square, Warrenton, Virginia 20186.

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

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

investments and deposit sweeps through the transfer and/or exchange with other FDIC insured institutions. CDARS and ICS are registered service marks of Promontory Interfinancial Network, LLC.

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

The Bank, through its subsidiary Fauquier Bank Services, Inc., has equity ownership interests in Bankers Insurance, LLC, a Virginia independent insurance company, Bankers Title Shenandoah, LLC, a title insurance company, and Infinex Investments, Inc., a full service broker/dealer. Bankers Insurance and Bankers Title Shenandoah are owned by a consortium of Virginia community banks, and Infinex is owned by banks and banking associations in various states.

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

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

As of June 30, 2014, the Company had total consolidated assets of \$600.8 million, total loans net of allowance for loan losses of \$436.6 million, total consolidated deposits of \$522.8 million, and total consolidated shareholders' equity of \$53.5 million.

CRITICAL ACCOUNTING POLICIES

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

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

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

Specifically, the Company uses both external and internal qualitative factors when determining the non-loan-specific allowances. The external factors utilized include: unemployment in the Company's defined market area of Fauquier County, Prince William County, and the City of Manassas ("market area"), as well as state and national unemployment trends; new residential construction permits for the market area; bankruptcy statistics for the Virginia Eastern District and trends for the United States; and foreclosure statistics for the market area and the state. Quarterly, these external qualitative factors as well as relevant anecdotal information are evaluated from data compiled from

local periodicals such as The Washington Post, The Fauquier Times Democrat, and The Bull Run Observer, which cover the Company's market area. Additionally, data is gathered from the Federal Reserve Beige Book for the Richmond Federal Reserve District, Global Insight's monthly economic review, the George Mason School of Public Policy Center for Regional Analysis, and daily economic updates from various other sources. Internal Bank data utilized includes: loans past due aging statistics, nonperforming loan trends, trends in collateral values, loan concentrations, loan review status downgrade trends, and lender turnover and experience trends. Both external and internal data is analyzed on a rolling eight quarter basis to determine risk profiles for each qualitative factor. Ratings are assigned through a defined matrix to calculate the allowance consistent with authoritative accounting literature. A narrative summary of the reserve allowance is produced quarterly and reported directly to the Company's Board of Directors. The Company's application of these qualitative factors to the allowance for loan losses has been consistent over the reporting period.

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

EXECUTIVE OVERVIEW

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

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

Net income of \$1,239,000 for the second quarter of 2014 was a 54.1% increase from the net income for the second quarter of 2013 of \$804,000. Loans, net of reserve, totaling \$436.6 million at June 30, 2014, decreased 1.8% when compared with December 31, 2013, and increased 0.1% when compared with June 30, 2013. Deposits, totaling \$522.8 million at June 30, 2014, decreased 3.2% compared with December 31, 2013, and increased 0.7% when compared with June 30, 2013. Assets under WMS management, totaling \$429.3 million in market value at June 30, 2014, increased 10.1% from December 31, 2013 and 20.5% from June 30, 2013.

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

The Bank's non-performing assets totaled \$4.8 million or 0.81% of total assets at June 30, 2014, as compared with \$7.6 million or 1.23% of total assets at December 31, 2013, and \$8.2 million or 1.39% of total assets at June 30, 2013. Nonaccrual loans totaled \$2.2 million or 0.50% of total loans at June 30, 2014 compared with \$2.2 million or 0.48% of total loans at December 31, 2013, and \$6.7 million or 1.51% of total loans at June 30, 2013. There was no provision for loan losses for the first six months of 2014 compared with \$967,000 for the first six months of 2013. The significant decrease in the provision for loan losses was due to the reduction in historical delinquency and credit loss experience trends. During the first six months ended June 30, 2014, there were net recoveries of \$86,000 or 0.02% of total average loans compared with net charge-offs of \$389,000 or 0.09% of total average loans for the same six months of 2013. Total allowance for loan losses was \$6.8 million or 1.52% of total loans at June 30, 2014 compared with \$6.7 million or 1.48% of loans at December 31, 2013 and \$6.8 million or 1.54% of loans at June 30, 2013.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2014 AND 2013

NET INCOME

Net income of \$1,239,000 for the quarter ended June 30, 2014 was a 54.1% increase from the net income for the quarter ended June 30, 2013 of \$804,000. Earnings per share on a fully diluted basis were \$0.33 for the second quarter of 2014 compared with \$0.22 for the second quarter of 2013. Profitability as measured by return on average assets increased from 0.54% in the second quarter of 2013 to 0.83% for the same period in 2014. Profitability as

measured by return on average equity increased from 6.65% to 9.35% over the same respective quarters in 2013 and 2014. The increase in net income was primarily due to the \$800,000 decrease in the provision for loan losses in the second quarter of 2014 compared with the second quarter of 2013, partially offset by the \$102,000 decrease in net interest income over the same periods.

NET INTEREST INCOME AND EXPENSE

Net interest income decreased \$102,000 or 2.1% to \$4.82 million for the quarter ended June 30, 2014 from \$4.92 million for the quarter ended June 30, 2013. The decrease in net interest income was due primarily to the decrease in interest and fees on loans. This was partially offset by reduced interest expense on deposits and FHLB advances over the same period. The Company's net interest margin decreased from 3.60% in the second quarter of 2013 to 3.55% in the second quarter of 2014.

Total interest income decreased \$269,000 or 4.7% to \$5.48 million for the second quarter of 2014 from \$5.75 million for the second quarter of 2013. This decrease was primarily due to the decline in the yield on earning assets from 4.19% during the second quarter of 2013 to 4.02% during the second quarter of 2014.

The tax-equivalent average yield on loans was 4.58% for the second quarter of 2014, down from 4.89% in the second quarter of 2013. Average loan balances decreased \$2.4 million or 0.5% from \$446.6 million during the second quarter of 2013 to \$444.2 million during the second quarter of 2014. The decrease in balances and yield resulted in a \$383,000 or 7.1% decline in interest and fee income from loans for the second quarter of 2014, compared with the same period in 2013. On a tax equivalent basis, the decrease was \$377,000 or 6.9%.

Average investment security balances increased \$7.3 million from \$49.8 million in the second quarter of 2013 to \$57.1 million in the second quarter of 2014. The tax-equivalent average yield on investments increased from 2.65% for the second quarter of 2013 to 3.09% for the second quarter of 2014. Interest and dividend income on security investments increased \$111,000 or 37.1%, from \$299,000 for the second quarter of 2013 to \$410,000 for the second quarter of 2014. Approximately \$79,000 of the increase in interest income on securities was due to the receipt and recognition of past due interest on the Bank's investment in trust preferred securities. For further discussion on trust preferred securities, see "Securities" in Note 2 of the Notes to Consolidated Financial Statements contained herein. Interest income on deposits in other banks increased \$3,000 from second quarter 2013 to second quarter 2014 resulting from increased balances in certificates of deposits at other banks.

Total interest expense decreased \$167,000 or 20.3% from \$824,000 for the second quarter of 2013 to \$657,000 for the second quarter of 2014 primarily due to the decline in average balances of time deposits and FHLB advances.

Interest paid on deposits decreased \$53,000 or 9.2% from \$579,000 for the second quarter of 2013 to \$526,000 for the second quarter of 2014. Average balances on time deposits declined \$27.7 million or 22.0% from \$125.8 million to \$98.1 million while the average rate increased from 1.38% for the second quarter of 2013 to 1.50% for the second quarter of 2014, resulting in \$67,000 less interest expense. Average money market account balances increased \$8.1 million from the second quarter of 2013 to the second quarter of 2014 while the rate increased from 0.18% to 0.21%, resulting in \$8,000 more interest expense. Average savings account balances increased \$5.0 million or 7.0% from the second quarter of 2013 to the second quarter of 2014, while the average rate declined from 0.12% to 0.11%, resulting in a decrease of \$1,000 of interest expense for the second quarter of 2014. Average interest bearing checking balances increased \$18.5 million or 9.9% from the second quarter of 2013 to the second quarter of 2014, while the average rate decreased from 0.23% to 0.22%, resulting in an increase of \$7,000 in checking interest expense for the second quarter of 2014.

From the second quarter of 2013 to the second quarter of 2014, interest expense on FHLB advances decreased \$114,000 or 58.5% due to a decrease in average balances from \$23.5 million during the three months ended June 30, 2013 to \$13.1 million during the three months ended June 30, 2014, while the average rate paid declined from 3.34% to 2.49% over the same time periods. Interest expense on capital securities was \$50,000 for the second quarter of 2013 and the second quarter of 2014.

The average rate on total interest-bearing liabilities decreased from 0.72% in the second quarter of 2013 to 0.59% for the second quarter of 2014.

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

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

(Dollars in thousands)	Three Months Ended June 30, 2014				Three Months Ended June 30, 2013			
	Average Balances	Income/Expense	Average Rate		Average Balances	Income/Expense	Average Rate	
Assets								
Loans								
Taxable	\$435,278	\$4,941	4.55	%	\$430,330	\$5,334	4.97	%
Tax-exempt (1)	7,038	130	7.38	%	7,234	114	6.34	%
Nonaccrual (2)	1,933	-			9,083	-		
Total Loans	444,249	5,071	4.58	%	446,647	5,448	4.89	%
Securities								
Taxable	50,418	348	2.76	%	42,993	237	2.21	%
Tax-exempt (1)	6,645	93	5.60	%	6,795	93	5.48	%
Total securities	57,063	441	3.09	%	49,788	330	2.65	%
Deposits in banks	52,220	43	0.33	%	59,924	40	0.27	%
Federal funds sold	13	-	0.15	%	10	-	0.16	%
Total earning assets	553,545	5,555	4.02	%	556,369	\$5,818	4.19	%
Less: Reserve for loan losses	(6,772)				(6,352)			
Cash and due from banks	5,070				5,081			
Bank premises and equipment, net	19,808				15,064			
Other real estate owned	1,406				1,406			
Other assets	24,933				25,978			
Total Assets	\$597,990				\$597,546			
Liabilities and Shareholders' Equity								
Deposits								
Demand deposits	\$87,756				\$85,414			
Interest-bearing deposits								
Checking accounts	205,092	\$112	0.22	%	186,619	\$105	0.23	%
Money market accounts	52,062	28	0.21	%	44,006	20	0.18	%
Savings accounts	77,240	20	0.11	%	72,203	21	0.12	%

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Time deposits	98,105	366	1.50	%	125,813	433	1.38	%
Total interest-bearing deposits	432,499	526	0.49	%	428,641	579	0.54	%
Federal funds purchased	8	-	0.00	%	2	-	0.50	%
Federal Home Loan Bank advances	13,115	81	2.49	%	23,507	195	3.34	%
Capital securities of subsidiary trust	4,124	50	4.83	%	4,124	50	4.83	%
Total interest-bearing liabilities	449,746	657	0.59	%	456,274	824	0.72	%
Other liabilities	7,306				7,317			
Shareholders' equity	53,182				48,541			
Total Liabilities & Shareholders' Equity	\$ 597,990				\$ 597,546			
Net interest spread		\$ 4,898	3.43	%		\$ 4,994	3.47	%
Interest expense as a percent of average earning assets			0.48	%			0.59	%
Net interest margin			3.55	%			3.60	%

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

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

RATE VOLUME ANALYSIS

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

(In thousands)	Three Months Ended June 30, 2014 Compared to Three Months Ended June 30, 2013		
	Change	Due to Volume	Due to Rate
Interest Income			
Loans; taxable	\$(393)	\$ 61	\$(454)
Loans; tax-exempt (1)	16	(3)	19
Securities; taxable	111	41	70
Securities; tax-exempt (1)	-	(2)	2
Deposits in banks	3	(5)	8
Federal funds sold	-	-	-
Total Interest Income	\$(263)	\$ 92	\$(355)
Interest Expense			
Checking accounts	\$ 7	\$ 11	\$ (4)
Money market accounts	8	4	4
Savings accounts	(1)	1	(2)
Time deposits	(67)	(95)	28
Federal funds purchased and securities sold under agreements to repurchase	-	-	-
Federal Home Loan Bank advances	(114)	(87)	(27)
Capital securities of subsidiary trust	-	-	-
Total Interest Expense	(167)	(166)	(1)
Net Interest Income	\$ (96)	\$ 258	\$ (354)

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

PROVISION FOR LOAN LOSSES

There was no provision for loan losses for the second quarter of 2014 compared with \$800,000 for the second quarter of 2013. The amount of the provision for loan loss is based upon management's continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank's delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. 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 \$800,000 decrease in the provision for loan losses was primarily due to the declines in historical delinquency and credit loss experience trends.

OTHER INCOME

Total other income decreased by \$41,000 or 2.4% from \$1.74 million for the second quarter of 2013 to \$1.70 million in the second quarter of 2014. Non-interest income is derived primarily from recurring non-interest fee income, which consists primarily of fiduciary trust and other Wealth Management fees, brokerage fees, service charges on deposit accounts, debit card interchange income and other fee income. The decrease was primarily due to a \$83,000 decrease in service charges on deposit accounts and a \$27,000 decrease in brokerage income during the second quarter of 2014 compared with the second quarter of 2013, partially offset by a \$67,000 increase in trust and estate income.

Trust and estate income increased \$67,000 or 17.4% from the second quarter of 2013 to the second quarter of 2014 primarily due to increased growth of managed investment accounts.

Brokerage service revenues decreased \$27,000 or 24.5% from the second quarter of 2013 to the second quarter of 2014 due to more client business directed to managed investment accounts in the Bank's trust department.

Service charges on deposit accounts decreased \$83,000 or 11.2% to \$660,000 for the second quarter of 2014 compared to one year earlier. The reason for the change is difficult to determine, but may be due to changes in consumer behavior in their personal funds management because of greater access to account information via mobile technology.

Other service charges, commissions and fees increased \$2,000 or 0.4% from \$501,000 in second quarter of 2013 to \$503,000 in the second quarter of 2014. Included in other service charges, commissions, and income is debit card interchange income, net, which totaled \$313,000 and \$312,000 for the second quarters of 2014 and 2013, respectively. Also included is bank owned life insurance ("BOLI") income, which was \$96,000 during the three months ended June 30, 2014, compared with \$99,000 one year earlier.

OTHER EXPENSE

Total other expense increased \$25,000 or 0.5% during the second quarter of 2014 compared with the second quarter of 2013, primarily due to the increase in salaries and benefits, occupancy expenses, and other operating expenses partially offset by a decrease in legal and consulting expense..

Salaries and employees' benefits increased \$115,000 or 4.8% from second quarter 2013 to second quarter 2014. The increase was primarily due to the annual increases in salaries, and increases in commissions for the second quarter of 2014 compared with the second quarter of 2013. Additionally, active full-time equivalent employees increased from 142 as of June 30, 2013 to 144 as of June 30, 2014. At June 30, 2014, the Company had approximately ten full-time equivalent positions to be filled over the remainder of 2014, partially due to the staffing of the new Centreville Road-Manassas branch.

Occupancy expense increased \$57,000 or 12.0%, due to expenses associated with the opening of the Gainesville branch location in the second quarter of 2014. Furniture and equipment expense decreased \$25,000 or 9.6%, from second quarter 2013 to second quarter 2014 due to reduced expenditures on technology equipment and software.

Marketing expense decreased \$8,000 or 5.3% from the second quarter of 2013 to \$142,000 for the second quarter of 2014.

Legal, accounting and consulting expense decreased \$195,000 or 58.6% from the second quarter of 2013 to \$138,000 for the second quarter of 2014 primarily due to the reduction in management consulting expense, as well as legal expenses associated with problem loan workouts.

Data processing expense increased \$19,000 or 5.8% for the second quarter of 2014 compared with the same time period in 2013 due to the growth in customer accounts and transactions processed. The Bank outsources much of its data processing to third-party vendors.

FDIC deposit insurance expense decreased \$50,000 from \$132,000 for the second quarter of 2013 to \$82,000 for the second quarter of 2014 due to improvements in the qualitative factors used to calculate the FDIC deposit insurance premium expense.

Other operating expenses increased \$109,000 or 15.1% in the second quarter of 2014 compared with the second quarter of 2013 due to a variety of factors including increased supplies expense and non-loan charge-offs.

INCOME TAXES

Income tax expense was \$430,000 for the quarter ended June 30, 2014 compared with \$233,000 for the quarter ended June 30, 2013. The effective tax rate was 25.8% and 22.5% for the second quarter of 2014 and 2013, respectively. The effective tax rate differed from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, income from the BOLI purchases, and community development tax credits.

COMPARISON OF OPERATING RESULTS FOR THE SIX MONTHS ENDED JUNE 30, 2014 AND 2013

NET INCOME

Net income of \$2.23 million for the six months ended June 30, 2014 was a 26.4% increase from the net income for the six months ended June 30, 2013 of \$1.77 million. Earnings per share on a fully diluted basis were \$0.60 for the six months ended June 30, 2014 compared with \$0.47 for the six months ended June 30, 2013. Profitability as measured by return on average assets increased from 0.60% in the six months ended June 30, 2013 to 0.75% for the same period in 2014. Profitability as measured by return on average equity increased from 7.38% to 8.57% over the same respective six months in 2013 and 2014. The increase in net income was primarily due to the \$967,000 reduction in the provision for loan losses for the six months ended June 30, 2014 compared with the six months ended June 30, 2013, partially offset by the \$88,000 decrease in net interest income and \$167,000 increase in total other expenses over the same time periods.

NET INTEREST INCOME AND EXPENSE

Net interest income decreased \$88,000 or 0.9% to \$9.68 million for the six months ended June 30, 2014 from \$9.77 million for the six months ended June 30, 2013. The decrease in net interest income was due primarily to the decline in loan balances and yields, partially offset by increased balances and yields on security investments. The Company's net interest margin decreased from 3.60% for the six months ended June 30, 2013 to 3.59% for the six months ended June 30, 2014.

Total interest income decreased \$482,000 or 4.2% to \$10.99 million for the six months ended June 30, 2014 from \$11.47 million for the six months ended June 30, 2013. This decrease was primarily due to reduced average loan balances and a 16 basis point decline in the yield on average earning assets over the respective time periods on a tax equivalent basis.

The tax-equivalent average yield on loans was 4.61% for the six months ended June 30, 2014, down from 4.90% during the same time period in the prior year. Average loan balances decreased \$1.7 million or 0.4% to \$446.9 million during the six months ended June 30, 2014 from \$448.5 million during the six months ended June 30, 2013. The decrease in balances and yield resulted in a \$669,000 or 6.2% decline in interest and fee income from loans for the six months ended June 30, 2014 compared with the same period in 2013. On a tax equivalent basis, the decrease was \$666,000 or 6.1%.

Average investment security balances increased \$6.4 million from \$49.6 million for the six months ended June 30, 2013 to \$56.0 million in the six months ended June 30, 2014. The tax-equivalent average yield on investments increased from 2.58% to 2.96% over the same respective time periods. Interest and dividend income on security investments increased \$190,000 or 33.0%, from \$576,000 for the six months ended June 30, 2013 to \$766,000 for the six months ended June 30, 2014. On a tax equivalent basis, the increase was \$190,000 or 29.7%. Approximately \$101,000 of the increase in interest income on securities was due to the receipt and recognition of past due interest on the Bank's investment in trust preferred securities. For further discussion on trust preferred securities, see "Securities" in Note 2 of the Notes to Consolidated Financial Statements contained herein.

Interest income on deposits in other banks decreased \$3,000 from \$84,000 to \$81,000 resulting from lower earning balances at the Federal Reserve over the first six months of 2014 compared with the same period in the prior year.

Total interest expense decreased \$394,000 or 23.1% from \$1.70 million for the six months ended June 30, 2013 to \$1.31 million for the six months ended June 30, 2014, primarily due to the decline in interest paid on time deposits and FHLB advances.

Interest paid on deposits decreased \$116,000 or 10.0% from \$1.16 million for the six months ended June 30, 2013 to \$1.05 million for the six months ended June 30, 2014. Average balances on time deposits declined \$23.5 million or 18.6% from \$126.4 million to \$102.9 million while the average rate increased from 1.38% to 1.44% from the six months ended June 30, 2013 to the six months ended June 30, 2014, resulting in \$133,000 less interest expense. Average money market accounts increased \$5.9 million or 13.5% from the six months ended June 30, 2013 to the six months ended June 30, 2014 while the rate increased from 0.18% to 0.21%, resulting in \$13,000 more interest expense. Average savings account balances increased \$6.5 million from the six months ended June 30, 2013 to the six months ended June 30, 2014, while their average rate was 0.14% and 0.11% over the same respective periods, resulting in a decrease of \$6,000 of interest expense. Average interest bearing checking balances increased \$18.6 million from the six months ended June 30, 2013 to the six months ended June 30, 2014, while the average rate decreased from 0.23% to 0.22%, resulting in a increase of \$10,000 in checking interest expense.

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Interest expense on FHLB advances decreased \$278,000 due to a decrease in average balances of \$12.7 million and the average rate of 95 basis points from the first six months of 2013 to the first six months of 2014. Interest expense on capital securities was \$99,000 for both the six months ended June 30, 2014 and 2013.

The average rate on total interest-bearing liabilities decreased from 0.75% for the six months ended June 30, 2013 to 0.59% for the six months ended June 30, 2014.

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

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

(Dollars in thousands)	Six Months Ended June 30, 2014				Six Months Ended June 30, 2013			
	Average Balances	Income/Expense	Average Rate		Average Balances	Income/Expense	Average Rate	
Assets								
Loans								
Taxable	\$437,660	\$9,983	4.60	%	\$431,188	\$10,659	4.98	%
Tax-exempt (1)	6,942	238	6.90	%	7,262	228	6.34	%
Nonaccrual (2)	2,250	-	-		10,052	-	\$ -	
Total Loans	446,852	10,221	4.61	%	448,502	10,887	4.90	%
Securities								
Taxable	49,377	643	2.60	%	42,756	453	2.12	%
Tax-exempt (1)	6,615	186	5.63	%	6,823	186	4.56	%
Total securities	55,992	829	2.96	%	49,579	639	2.58	%
Deposits in banks	49,363	81	0.33	%	57,051	84	0.30	%
Federal funds sold	10	-	0.19	%	10	-	0.16	%
Total earning assets	552,217	\$11,131	4.06	%	555,142	\$11,610	4.22	%
Less: Reserve for loan losses	(7,066)				(6,399)			
Cash and due from banks	5,062				5,069			
Bank premises and equipment, net	19,041				14,889			
Other real estate owned	2,526				1,406			
Other assets	25,118				25,751			
Total Assets	\$596,898				\$595,858			
Liabilities and Shareholders' Equity								
Deposits								
Demand deposits	\$87,055				\$85,314			
Interest-bearing deposits								
Checking accounts	203,675	\$220	0.22	%	185,097	\$210	0.23	%
Money market accounts	49,807	51	0.21	%	43,901	38	0.18	%
Savings accounts	76,414	41	0.11	%	69,919	47	0.14	%
Time deposits	102,877	735	1.44	%	126,393	868	1.38	%

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Total interest-bearing deposits	432,773	1,047	0.49	%	425,310	1,163	0.55	%
Federal funds purchased	4	-	0.75	%	3	-	0.53	%
Federal Home Loan Bank advances	13,123	162	2.49	%	25,837	440	3.44	%
Capital securities of subsidiary trust	4,124	99	4.83	%	4,124	99	4.83	%
Total interest-bearing liabilities	450,024	1,308	0.59	%	455,274	1,702	0.75	%
Other liabilities	7,268				6,985			
Shareholders' equity	52,551				48,285			
Total Liabilities & Shareholders' Equity	\$596,898				\$595,858			
Net interest spread		\$9,823	3.47	%		\$9,908	3.47	%
Interest expense as a percent of average earning assets			0.48	%			0.62	%
Net interest margin			3.59	%			3.60	%

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

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

RATE VOLUME ANALYSIS

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

(In thousands)	Six Months Ended June 30, 2014 Compared to Six Months Ended June 30, 2013		
	Change	Due to Volume	Due to Rate
Interest Income			
Loans; taxable	\$ (676)	\$ 160	\$ (836)
Loans; tax-exempt (1)	10	(10)	20
Securities; taxable	190	70	120
Securities; tax-exempt (1)	-	(6)	6
Deposits in banks	(3)	(11)	8
Federal funds sold	-	-	-
Total Interest Income	(479)	203	(682)
Interest Expense			
Checking accounts	10	21	(11)
Money market accounts	13	5	8
Savings accounts	(6)	4	(10)
Time deposits	(133)	(161)	28
Federal funds purchased and securities sold under agreements to repurchase	-	-	-
Federal Home Loan Bank advances	(278)	(217)	(61)
Capital securities of subsidiary trust	-	-	-
Total Interest Expense	(394)	(348)	(46)
Net Interest Income	\$ (85)	\$ 551	\$ (636)

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

PROVISION FOR LOAN LOSSES

There was no provision for loan losses for the six months ended June 30, 2014 compared with \$967,000 on for the six months ended June 30, 2013. The amount of the provision for loan loss is based upon management's continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank's delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. 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 \$967,000 million decrease in the provision for loan losses was primarily due to the reduction in in historical delinquency and credit loss experience trends.

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OTHER INCOME

Total other income decreased by \$59,000 or 1.9% from \$3.18 million for the six months ended June 30, 2013 to \$3.12 million in the six months ended June 30, 2014. The decrease in other income was primarily due to decreases in brokerage income, service charges on deposits, and other service charges during the six months ended June 30, 2014 compared with the six months ended June 30, 2013, partially offset by a \$153,000 increase in trust and estate income over the same time period.

Trust and estate income increased \$153,000 or 21.2% from the first six months of 2013 to the first six months ended June 30, 2014 due to increased growth of managed investment accounts.

Brokerage service revenues decreased \$83,000 or 34.2% from the first six months of 2013 to the first six months of 2014 due to more client business directed to managed investment accounts in the Bank's trust department.

Service charges on deposit accounts decreased \$61,000 or 4.6% to \$1.27 million for the six months ended June 30, 2014 compared to the same period one year earlier.

Other service charges, commissions and fees decreased \$68,000 or 7.7% from \$886,000 during the six months ended June 30, 2013 to \$818,000 during the six months ended June 30, 2014. Included in other service charges, commissions, and income is ATM/debit card interchange income which totaled \$578,000 and \$555,000 for the first six months of 2014 and 2013, respectively. Also included is BOLI income, which was \$190,000 during the six months ended June 30, 2014, compared with \$199,000 one year earlier. In addition, during the first quarter of 2014, \$70,000 of annual passive losses were taken on low income housing investments, which provide current and future tax credits.

OTHER EXPENSE

Total other expense increased \$167,000 or 1.7% during the six months ended June 30, 2014 compared with the six months ended June 30, 2013. The increase was primarily due to increased expenses related to salaries and benefits and occupancy expenses, partially offset by decreased legal, audit, consulting expense, the reduction in FDIC premium expense and gain on sale of OREO.

Salaries and employees' benefits increased \$315,000 or 6.5% from the six months ended June 30, 2013 to the six months ended June 30, 2014 due to the same factors discussed in the three month review of operating results.

Occupancy expense increased \$145,000 or 15.1%, while furniture and equipment expense increased \$8,000 or 1.5%, for the year to date ended June 30, 2014 compared with the year to date ended June 30, 2013 primarily due to the opening of the new Gainesville branch office, as well as increased snow removal expenses during the first quarter of 2014.

Marketing expense decreased \$7,000 or 2.4% from the six months ended June 30, 2013 to \$283,000 for the six months ended June 30, 2014.

Legal, accounting and consulting expense decreased \$241,000 or 37.8% from the six months ended June 30, 2013 to \$397,000 for the six months ended June 30, 2014 primarily due to legal expenses experienced in 2013, but not in 2014, associated with the management and disposition of problem hospitality loans.

Data processing expense increased \$58,000 or 9.0% for the six months ended June 30, 2014 compared with the same time period in 2013 due to the growth in customer accounts and transactions processed.

FDIC deposit insurance expense decreased \$83,000 or 31.0% from \$268,000 for the six months ended June 30, 2013 to \$185,000 for the six months ended June 30, 2014 due to improvements in the qualitative factors used to calculate FDIC expense.

Loss on sale or impairment and expense on other real estate owned ("OREO") decreased \$112,000 for the first half of 2014 due to a gain of \$130,000 on the sale of one property.

Other operating expenses increased \$84,000 or 5.5% in the six months ended June 30, 2014 compared with the six months ended June 30, 2013.

INCOME TAXES

Income tax expense was \$733,000 for the six months ended June 30, 2014 and \$546,000 for the six months ended June 30, 2013. The effective tax rate was 24.7% and 23.6% for the first six months of 2014 and 2013, respectively. The effective tax rate differed from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, income from the BOLI purchases, and community development tax credits.

COMPARISON OF FINANCIAL CONDITION AT JUNE 30, 2014 AND DECEMBER 31, 2013

Total assets were \$600.8 million at June 30, 2014 compared with \$615.8 million at December 31, 2013, a decrease of 2.4% or \$15.0 million. Balance sheet categories reflecting significant changes include interest-bearing deposits in other banks, securities available for sale, loans, other real estate owned, net, bank premises and equipment, net, and deposits. Each of these categories is discussed below.

INTEREST-BEARING DEPOSITS IN OTHER BANKS. Interest-bearing deposits in other banks were \$53.7 million at June 30, 2014, a decrease of \$11.3 million from December 31, 2013. The reduction in this account is primarily due to the decrease in deposits reducing the amount of excess liquidity in the Bank.

SECURITIES AVAILABLE FOR SALE. Securities available for sale were \$57.7 million at June 30, 2014, an increase of \$4.2 million or 7.8% from December 31, 2013, primarily due to the purchase of U.S. Government securities.

LOANS. Loans, net of allowance for loan losses, were \$436.6 million at June 30, 2014, reflecting a decrease of \$8.2 million from \$444.7 million at December 31, 2013.

OTHER REAL ESTATE OWNED, NET. Other real estate owned, net, decreased \$2.7 million to \$1.4 million due to the sale of one property, a 176 acre restaurant/inn/spa in Casanova, Virginia. The remaining OREO consists of 47 acres of undeveloped land in Opal, Virginia.

BANK PREMISIES AND EQUIPMENT, NET. Bank premises and equipment, net, increased \$4.7 million due to the purchase of an existing branch property in Manassas, Virginia and building of a new branch office in Gainesville, Virginia.

DEPOSITS. For the six months ended June 30, 2014, total deposits decreased by \$17.5 million or 3.2% when compared with total deposits at December 31, 2013. Non-interest-bearing deposits increased \$1.4 million to \$89.8, while interest-bearing deposits decreased by \$18.8 million to \$433.0 million at June 30, 2014 from December 31, 2013. Included in interest-bearing deposits at June 30, 2014 and December 31, 2013 were \$7.3 million and \$15.6 million, respectively, of brokered deposits as defined by the Federal Reserve. Of the \$7.3 million in brokered deposits, \$2.9 million represent deposits of Bank customers, exchanged through the CDARS' network. With the CDARS' program, funds are placed into certificate of deposits issued by other banks in the network, in increments of less than \$250,000, to ensure both principal and interest are eligible for complete FDIC coverage. These deposits are exchanged with other member banks on a dollar-for-dollar basis, bringing the full amount of our customers' deposits back to the Bank and making these funds fully available for lending in our community. The decrease in the Bank's interest-bearing deposits during the first six months of 2014 were the result of many factors difficult to segregate and quantify, and equally difficult to use as factors for future projections. The economy, local competition, retail customer preferences, changes in seasonal cash flows by both commercial and retail customers, changes in business cash management practices by Bank customers, the relative pricing from wholesale funding sources, the in-and-outflow of local government tax receipts, and the Bank's funding needs all contributed to the change in deposit balances. The Bank projects to increase its transaction accounts and other deposits during the remainder of 2014 and beyond through the expansion of its branch network, as well as by offering value-added interest checking and demand deposit products, and selective rate premiums on its interest-bearing deposits.

ASSET QUALITY

Non-performing assets primarily consist of loans that are 90 days or more past due and for which the accrual of interest has been discontinued. Management evaluates all loans that are 90 days or more past due, as well as borrowers that have suffered financial distress, to determine if they should be placed on non-accrual status. Factors considered by management include the net realizable value of collateral, if any, and other resources of the borrower that may be available to satisfy the delinquency.

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

Non-performing assets totaled \$4.8 million or 0.81% of total assets at June 30, 2014, compared with \$7.6 million or 1.23% of total assets at December 31, 2013, and \$8.2 million or 1.39% of total assets at June 30, 2013. Included in non-performing assets at June 30, 2014 were \$1.2 million of non-performing pooled trust preferred bonds at market value, \$1.4 million of OREO and \$2.2 million of non-accrual loans. Non-accrual loans as a percentage of total loans were 0.50% at June 30, 2014, as compared with 0.48% and 1.51% at December 31, 2013 and June 30, 2013, respectively.

Student loans that were past due 90 days or more and still accruing interest totaled \$2.9 million at June 30, 2014, \$7.9 million at December 31, 2013 and \$3.2 million at June 30, 2013. These loans continue to accrue interest when past due because repayment of both principal and accrued interest are 98% guaranteed by the U.S. Department of Education. Other loans that were past due 90 days or more and still accruing interest totaled \$1,000 at June 30, 2014, compared with \$506,000 on December 31, 2013 and \$355,000 at June 30, 2013. During the quarter ended June 30, 2014, there were two loans newly identified as troubled debt restructurings ("TDRs"). At the end of the quarter, 15 TDRs, totaling \$9.5 million, were in the loan portfolio. Eleven of the loans, totaling \$8.3 million, were on accrual status and performing in accordance with the modified terms. The remaining four loans, totaling \$1.2 million, remained in nonaccrual status due to irregular payments. Appropriate specific reserves have been established.

Restructured loans are included in the specific reserve calculation in the allowance for loan losses and are included in impaired loans.

For additional information regarding non-performing assets and potential loan problems, see "Loans and Allowance for Loan Losses" in Note 3 of the Notes to Consolidated Financial Statements contained herein.

At June 30, 2014, no concentration of loans and loan commitments to commercial borrowers engaged in similar activities exceeded 5% of total gross loans. The largest industry concentration of loans and loan commitments at June 30, 2014 was approximately \$13.3 million of loans to customers in the childcare industry, or 3.0% of total gross loans.

Based on regulatory guidelines, the Bank is required to monitor the commercial investment real estate loan portfolio for: (a) concentrations above 100% of Tier 1 capital and loan loss reserve for commercial construction and land loans and (b) 300% for permanent investor commercial real estate loans. As of June 30, 2014, commercial construction and land loans were \$29.2 million or 48.2% of the concentration limit. Commercial investor real estate loans, including commercial construction and land loans, were \$129.4 million or 213.7% of the concentration guideline.

CONTRACTUAL OBLIGATIONS

As of June 30, 2014, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in "Management's Discussion and Analysis and Results of Operations" in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

OFF-BALANCE SHEET ARRANGEMENTS

As of June 30, 2014, there have been no material changes to the off-balance sheet arrangements disclosed in "Management's Discussion and Analysis and Results of Operations" in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and discretionary actions by regulators that could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier 1 Capital to average assets (as defined in the regulations). Management believes, as of June 30, 2014, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

At June 30, 2014 and December 31, 2013, the Company exceeded its regulatory capital ratios, as set forth in the following table:

Risk Based Capital Ratios

	June 30, 2014	December 31, 2013
(Dollars in thousands)		
Tier 1 Capital:		
Shareholders' Equity	\$53,504	\$51,227
Plus: Unrealized loss on securities available for sale, net	33	847
Less: Unrealized loss on equity securities, net	-	-
Plus: Accumulated net loss on hedges	146	94
Plus: Company-obligated mandatorily redeemable capital securities	4,000	4,000
Less: Disallowed deferred tax assets	-	-
Total Tier 1 Capital	57,683	56,168
Tier 2 Capital:		
Allowable Allowance for Loan Losses	5,251	5,303
Total Capital:	\$62,934	\$61,471
Risk Weighted Assets:	\$418,589	\$422,885
Regulatory Capital Ratios:		
Leverage Ratio	9.65 %	9.24 %

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Tier 1 to Risk Weighted Assets	13.78	%	13.28	%
Total Capital to Risk Weighted Assets	15.03	%	14.54	%

On July 2, 2013, the Federal Reserve Board adopted a final rule ("new rule") for the U. S. implementation of the Basel III accords for banking organizations. This new rule will result in higher minimum capital requirements that better reflect banking organizations' risk profiles, and establishes criteria that capital instruments must meet in order to be considered common equity Tier 1 capital, additional Tier 1 capital, or Tier 2 capital. The minimum capital to risk-weighted assets requirements include: a new common equity Tier 1 capital ratio of 4.50%; a revised Tier 1 capital ratio of 6.00%, which is an increase from 4.00%, and the total capital ratio that remains at 8.00%. The minimum leverage ratio (Tier 1 capital to total assets) is 4.00%. The new rule maintains the general structure of the current prompt corrective action framework while incorporating these increased minimum requirements. The Bank is subject to the new rule on January 1, 2015, and management believes that the Bank will be fully compliant with the revised standards on the effective date.

CAPITAL RESOURCES AND LIQUIDITY

Shareholders' equity totaled \$53.5 million at June 30, 2014 compared with \$51.2 million at December 31, 2013 and \$48.1 million at June 30, 2013. The amount of equity reflects management's desire to increase shareholders' return on equity while maintaining a strong capital base. On January 16, 2014, the Company's Board of Directors authorized the Company to repurchase up to 111,400 shares (3% of common stock outstanding on January 1, 2014) beginning January 1, 2014 and continuing until the next Board reset. No shares were repurchased during the six months ended June 30, 2014. Accumulated other comprehensive income/loss was an unrealized loss, net of tax benefit, of \$179,000 at June 30, 2014 compared with an unrealized loss, net of tax benefit, of \$941,000 at December 31, 2013 and \$2.3 million at June 30, 2013.

As discussed in "Company-Obligated Mandatorily Redeemable Capital Securities" in Note 4 of the Notes to Consolidated Financial Statements contained herein, during 2006, the Company established a subsidiary trust that issued \$4.0 million of capital securities as part of a separate pooled trust preferred security offering with other financial institutions. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve's capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital. As discussed above under "Capital," banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios. As of June 30, 2014, the appropriate regulatory authorities have categorized the Company and the Bank as "well capitalized."

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

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled \$58.9 million at June 30, 2014 compared with \$71.1 million at December 31, 2013. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available for sale, of which approximately \$13.9 million was unpledged and readily salable at June 30, 2014. Furthermore, the Bank has an available line of credit with the FHLB with a borrowing limit of approximately \$142.8

million at June 30, 2014 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with the Federal Reserve and various other commercial banks totaling approximately \$57.1 million. At June 30, 2014, \$13.1 million of the FHLB line of credit and no federal funds purchased lines of credit were in use.

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The following table sets forth information relating to the Company's sources of liquidity and the outstanding commitments for use of liquidity at June 30, 2014 and December 31, 2013. 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)	June 30, 2014			December 31, 2013		
	Total	In Use	Available	Total	In Use	Available
Sources:						
Federal funds borrowing lines of credit	\$57,100	\$-	\$57,100	\$57,326	\$-	\$57,326
Federal Home Loan Bank advances	142,762	13,107	129,655	124,113	13,139	110,974
Federal funds sold and interest-bearing deposits in other banks, excluding requirements			28,476			37,967
Securities, available for sale and unpledged at fair value			13,851			13,445
Total short-term funding sources			\$229,082			\$219,712
Uses:						
Unfunded loan commitments and lending lines of credit			\$81,806			\$70,762
Letters of credit			4,657			7,515
Total potential short-term funding uses			\$86,463			\$78,277
Ratio of short-term funding sources to potential short-term funding uses			264.9	%		280.7
						%

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 U.S. GAAP, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of the Company and the Bank are monetary in nature. The impact of inflation is reflected in the increased cost of operations. As a result, interest rates have a greater impact on our performance than inflation does. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

CHANGES IN ACCOUNTING PRINCIPLES

For information regarding recent accounting pronouncements and their effect on the Company, see "Recent Accounting Pronouncements" in Note 1 of the Notes to Consolidated Financial Statements contained herein.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

There have been no material changes to the quantitative and qualitative disclosures made in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. There have not been any significant changes in the Company's internal control over financial reporting or in other factors that have materially affected or are reasonably likely to materially affect, such controls during the quarter ended June 30, 2014.

Part II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

Not applicable to smaller reporting companies.

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

On January 16, 2014, the Company's Board of Directors authorized the Company to repurchase up to 111,400 shares (3% of common stock outstanding on January 1, 2014) beginning January 1, 2014 and continuing until the next Board reset. No shares were repurchased during the three month period ended June 30, 2014.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

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Exhibit Exhibit
NumberDescription

- 3.1 Articles of Incorporation of Fauquier Bankshares, Inc., as amended, incorporated by reference to Exhibit 3.1 to Form 10-K filed March 15, 2010.
- 3.2 By-laws of Fauquier Bankshares, Inc., as amended and restated, incorporated by reference to Exhibit 3.2 to Form 10-Q filed August 9, 2010.
- 31.1 Certification of CEO pursuant to Rule 13a-14(a).
- 31.2 Certification of CFO pursuant to Rule 13a-14(a).
- 32.1 Certification of CEO pursuant to 18 U.S.C. Section 1350.
- 32.2 Certification of CFO pursuant to 18 U.S.C. Section 1350.

101.00 The following materials from the Company's Form 10-Q Report for the quarterly period ended June 30, 2014, formatted in XBRL: (1) Consolidated Balance Sheets, (2) Consolidated Statements of Income, (3) Consolidated Statements of Comprehensive Income (4) Consolidated Statements of Changes in Shareholders' Equity, (5) Consolidated Statements of Cash Flows and (6) the Notes to Consolidated Financial Statements.

SIGNATURES

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

FAUQUIER BANKSHARES, INC.
(Registrant)

/s/ Randy K. Ferrell
Randy K. Ferrell
President & Chief Executive Officer
Dated: August 14, 2014

/s/ Eric P. Graap
Eric P. Graap
Executive Vice President & Chief Financial Officer
Dated: August 14, 2014