FAUQUIER BANKSHARES, INC.
Form 10-Q
May 10, 2010

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

(Mark One)

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2010

or

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

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

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

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

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

Indicate by check mark whether the registrant 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 o No o

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

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

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

The registrant had 3,627,518 shares of common stock outstanding as of May 5, 2010.

FAUQUIER BANKSHARES, INC.

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Part I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Balance Sheets

	March 31, 2010 (Unaudited)	December 31, 2009 (Audited)
Assets		
Cash and due from banks	$ 6,990,352	$ 5,652,617
Interest-bearing deposits in other banks	16,465,087	20,546,596
Federal funds sold	9,032	9,154
Securities available for sale	36,973,670	36,692,094
Restricted investments	3,774,700	3,774,700
Loans, net of allowance for loan losses of $5,469,531 in 2010 and $5,481,963 in 2009	467,429,649	462,783,962
Bank premises and equipment, net	14,463,147	14,025,745
Accrued interest receivable	1,649,832	1,495,085
Other real estate owned	2,029,085	2,479,860
Other assets	20,810,756	21,022,655
Total assets	$ 570,595,310	$ 568,482,468
Liabilities and Shareholders Equity		
Deposits:		
Noninterest-bearing	$ 64,845,064	$ 68,469,699
Interest-bearing:		
NOW accounts	100,797,451	83,395,687
Savings and money market accounts	107,909,979	106,458,563
Time certificates of deposit	194,243,183	207,662,808
Total interest-bearing	402,950,613	397,517,058
Total deposits	467,795,677	465,986,757
Federal funds purchased		
Federal Home Loan Bank advances	50,000,000	50,000,000
Company-obligated mandatorily redeemable capital securities	4,124,000	4,124,000
Other liabilities	5,333,981	5,732,869
Commitments and contingencies		
Total liabilities	527,253,658	525,843,626
Shareholders Equity		
Common stock, par value, $3.13; authorized 8,000,000 shares: issued and outstanding, 2010: 3,620,544 shares (includes nonvested shares of 33,772); 2009: 3,594,685 shares (includes nonvested shares of 47,282)	11,226,596	11,103,371

Retained earnings	33,743,025	33,458,933
Accumulated other comprehensive income (loss), net	(1,627,969)	(1,923,462)
Total shareholders equity	43,341,652	42,638,842
Total liabilities and shareholders equity	$ 570,595,310	$ 568,482,468

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)
For the Three Months Ended March 31, 2010 and 2009

	2010	2009
Interest Income		
Interest and fees on loans	$ 6,691,277	$ 6,381,071
Interest and dividends on securities available for sale:		
Taxable interest income	302,656	356,163
Interest income exempt from federal income taxes	59,434	61,461
Dividends	6,816	4,463
Interest on federal funds sold	3	107
Interest on deposits in other banks	8,089	3,669
Total interest income	7,068,275	6,806,934
Interest Expense		
Interest on deposits	1,275,025	1,558,089
Interest on federal funds purchased		10,446
Interest on Federal Home Loan Bank advances	273,620	266,667
Distribution on capital securities of subsidiary trusts	19,325	35,835
Total interest expense	1,567,970	1,871,037
Net interest income	5,500,305	4,935,897
Provision for loan losses	375,000	200,000
Net interest income after provision for loan losses	5,125,305	4,735,897
Other Income		
Wealth management income	306,568	249,236
Service charges on deposit accounts	621,451	606,677
Other service charges, commissions and income	426,333	403,380
(Loss) on sale of other real estate owned	(16,139)	(135,759)
Gain on sale of investments	89,106	
Net other than temporary impairment losses on securities recognized in earnings (includes total other than temporary impairment losses of $560,548, net of $84,875 loss recognized in other comprehensive income for the quarter ended March 31, 2010 before tax benefit)	(475,673)	
Total other income	951,646	1,123,534

Other Expenses		
Salaries and benefits	2,447,688	2,354,939
Net occupancy expense of premises	499,902	307,067
Furniture and equipment	317,696	280,450
Marketing expense	156,418	120,978
Legal, audit and consulting expense	267,231	335,943
Federal Deposit Insurance Corporation expense	182,617	145,050
Data processing expense	358,105	348,494
Other operating expenses	799,328	702,046
Total other expenses	5,028,985	4,594,967
Income before income taxes	1,047,966	1,264,464
Income tax expense	244,073	341,555
Net Income	$ 803,893	$ 922,909
Earnings per Share, basic	$ 0.22	$ 0.26
Earnings per Share, assuming dilution	$ 0.22	$ 0.26
Dividends per Share	$ 0.20	$ 0.20

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders Equity
For the Three Months Ended March 31, 2010 and 2009

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
Balance, December 31, 2008	$ 11,036,687	$ 32,668,530	$ (2,217,280)		$ 41,487,937
Comprehensive income:					
Net income		922,909		$ 922,909	922,909
Other comprehensive income net of tax:					
Unrealized holding losses on securities available for sale, net of tax benefit of $535,793			(1,040,068)	(1,040,068)	(1,040,068)
Total comprehensive income				$ (117,159)	
Cash dividends ($.20 per share)		(719,307)			(719,307)
Amortization of unearned compensation, restricted stock awards		85,289			85,289
Issuance of common stock nonvested shares (10,585 shares)	33,131	(33,131)			
Exercise of stock options	27,293	54,484			81,777
Balance, March 31, 2009	$ 11,097,111	$ 32,978,774	$ (3,257,348)		$ 40,818,537
Balance, December 31, 2009	$ 11,103,371	$ 33,458,933	$ (1,923,462)		$ 42,638,842
Comprehensive income:					
Net income		803,893		$ 803,893	803,893
Other comprehensive income net of tax:					
Unrealized holding gains on securities available for sale, net of tax of $20,791			40,359	40,359	40,359
Less: gain on sale of securities available for sale, net net of tax of $30,296			(58,810)	(58,810)	(58,810)
Less: reclassification adjustments for other than temporary impairment, net of tax of $161,729			313,944	313,944	313,944

Other comprehensive income net of tax of $152,224				295,493	
Total comprehensive income				$ 1,099,386	
Cash dividends ($.20 per share)		(724,109)			(724,109)
Amortization of unearned compensation, restricted stock awards		205,260			205,260
Issuance of common stock nonvested shares (28,847 shares)	90,291	(90,291)			
Issuance of common stock vested shares (6,522 shares)	20,414	69,459			89,873
Exercise of stock options	12,520	19,880			32,400
Balance, March 31, 2010	$ 11,226,596	$ 33,743,025	$ (1,627,969)		$ 43,341,652

See accompanying Notes to Consolidated Financial Statements.

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
For the Three Months Ended March 31, 2010 and 2009
(Unaudited)

	2010	2009
Cash Flows from Operating Activities		
Net income	$ 803,893	$ 922,909
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	313,944	203,179
Provision for loan losses	375,000	200,000
Loss on sale of other real estate	16,139	135,759
(Gain) on sale of securities	(89,106)	
Loss on impairment of securities	475,673	
Amortization (accretion) of security premiums, net	9,058	(12,714)
Amortization of unearned compensation, net of forfeiture	205,260	85,289
Changes in assets and liabilities:		
(Increase) decrease in other assets	(96,708)	356,014
(Decrease) increase in other liabilities	(398,888)	254,812
Net cash provided by operating activities	1,614,265	2,145,248
Cash Flows from Investing Activities		
Proceeds from sale of securities available for sale	1,543,439	
Proceeds from maturities, calls and principal payments of securities available for sale	2,340,984	1,773,795
Purchase of securities available for sale	(4,112,271)	(2,978)
Purchase of premises and equipment	(751,346)	(592,101)
Purchase proceeds from sale of other bank stock		(719,900)
Net (increase) in loans	(5,020,687)	(8,870,845)
Proceeds from sale of other real estate owned	434,636	869,626
Net cash used in investing activities	(5,565,245)	(7,542,403)
Cash Flows from Financing Activities		
Net increase (decrease) in demand deposits, NOW accounts and savings accounts	15,228,545	(1,069,027)
Net (decrease) increase in certificates of deposit	(13,419,625)	17,056,272
Federal Home Loan Bank advances		80,000,000
Federal Home Loan Bank principal repayments		(65,000,000)
Purchase of federal funds		(18,275,000)
Cash dividends paid on common stock	(724,109)	(719,307)
Issuance of common stock	122,273	81,777
Net cash provided by financing activities	1,207,084	12,074,715

Increase (decrease) in cash and cash equivalents	(2,743,896)	6,677,560
Cash and Cash Equivalents		
Beginning	26,208,367	11,023,162
Ending	$ 23,464,471	$ 17,700,722
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 1,557,869	$ 1,967,496
Income taxes	$	$
Supplemental Disclosures of Noncash Investing Activities		
Unrealized gain (loss) on securities available for sale, net of tax effect	$ (18,451)	$ (1,040,068)

See accompanying Notes to Consolidated Financial Statements.

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

Note 1. General

The consolidated statements include the accounts of Fauquier Bankshares, Inc. (the Company) and its wholly-owned subsidiaries: The Fauquier Bank (the Bank) 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 March 31, 2010 and December 31, 2009 and the results of operations for the three months ended March 31, 2010 and 2009. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s 2009 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The results of operations for the three months ended March 31, 2010 are not necessarily indicative of the results expected for the full year.

Recent Accounting Pronouncements

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

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

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

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

In January 2010, the FASB issued Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In February 2010, the FASB issued Accounting Standards Update No. 2010-08, Technical Corrections to Various Topics. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements. ASU 2010-09 addresses both the interaction of the requirements of Topic 855 with the SEC s reporting requirements and the intended breadth of the reissuance disclosures provisions related to subsequent events. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. ASU 2010-09 is effective immediately. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

Note 2. Securities

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

	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized (Losses)**	**Fair Value**
	March 31, 2010			
Obligations of U.S. Government corporations and agencies	$ 28,142,404	$ 842,125	$ (16,494)	$ 28,968,035
Obligations of states and political subdivisions	5,569,835	276,408	(1,449)	5,844,794
Corporate Bonds	4,865,613		(3,038,031)	1,827,582
Mutual Funds	318,577		(818)	317,759
FHLMC Preferred Bank Stock	18,500		(3,000)	15,500
	$ 38,914,929	$ 1,118,533	$ (3,059,792)	$ 36,973,670

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

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

	March 31, 2010 Amortized Cost	Fair Value
Due in one year or less	$ 316,300	$ 317,600
Due after one year through five years	128,740	132,525
Due after five years through ten years	8,773,814	9,151,247
Due after ten years	29,358,998	27,039,039
Equity securities	337,077	333,259
	$ 38,914,929	$ 36,973,670

There were impairment losses on securities of $476,000 in the quarter ended March 31, 2010 and no impairment losses in the quarter ended March 31, 2009.

During the quarter ended March 31, 2010, one security, a 30 year mortgage-backed government agency with a fair value of $1.5 million, was sold at a gain of $89,000. This bond was sold because of its relatively longer term current duration of approximately five years, and its inherent extension risk of an additional two years of duration if market interest rates increase in the future. The tax expense on this gain on sale was $30,000. There were no securities sold in the quarter ended March 31, 2009.

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 March 31, 2010 and December 31, 2009, respectively.

March 31, 2010	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
Obligations of U.S. Government corporations and agencies	$ 6,019,556	$ (16,494)	$	$	$ 6,019,556	$ (16,494)
Obligations of states and political subdivisions			282,616	(1,449)	282,616	(1,449)
Corporate bonds			1,827,581	(3,038,031)	1,827,581	(3,038,031)
Subtotal, debt securities	6,019,556	(16,494)	2,110,197	(3,039,480)	8,129,753	(3,055,974)
Mutual funds			317,759	(818)	317,759	(818)
FHLMC preferred bank stock			15,500	(3,000)	15,500	(3,000)
Total temporary impaired securities	$ 6,019,556	$ (16,494)	$ 2,443,456	$ (3,043,298)	$ 8,463,012	$ (3,059,792)

December 31, 2009	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
Obligations of U.S. Government corporations and agencies	$ 3,030,782	$ (25,592)	$	$	$ 3,030,782	$ (25,592)

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

The nature of securities which are temporarily impaired for a continuous 12 month period or more at March 31, 2010 can be segregated into four groups:

The first group consists of four corporate bonds with a cost basis totaling $4.8 million and a temporary loss of approximately $3.0 million. The method for valuing these four corporate bonds came from Moody s Analytics. Moody s Analytics employs a two step discounted cash-flow valuation process. The first step is to use Monte Carlo simulations to evaluate the credit quality of the collateral pool and the structural supports. Step two is to apply a discount rate to the cash flows to calculate a value. These four corporate bonds are the Class B or subordinated mezzanine tranche of pooled trust preferred securities. The trust preferred securities are collateralized by the interest and principal payments made on trust preferred capital offerings by a geographically diversified pool of approximately 60 different financial institutions. They have an estimated maturity of 25 years. These bonds could have been called at par on the five year anniversary date of issuance, which has already passed for all four bonds. The bonds reprice every three months at a fixed rate index above the three-month London Interbank Offered Rate (LIBOR). These bonds have sufficient collateralization and cash flow projections to satisfy their valuation based on the cash flow portion of the (other than temporary impairment) OTTI test under authoritative accounting guidance as of March 31, 2010. All four bonds totaling $1.8 million at fair value, are greater than 90 days past due, and are classified as nonperforming corporate bond investments in the nonperforming asset table in Note 4.

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

Cost, net of OTTI loss	Fair Value	Percent of Underlying Current Collateral Performing	Percent of Underlying Collateral in Deferral	Percent of Underlying Collateral in Default	Estimated incremental defaults required to break yield (1)	Current Moody's Rating	Cumulative Amount of OTTI Loss	Cumulative Other Compreshensive Loss, net of tax benefit
$ 359,294	$ 102,362	56.6%	28.6%	14.8%	broken	Ca	$ 640,706	$ 169,575
1,822,050	746,034	76.3%	11.7%	12.0%	broken	Ca	177,950	710,171
1,899,350	779,749	77.9%	18.3%	3.8%	broken	Ca	100,650	738,937
784,919	199,436	73.9%	14.7%	11.4%	broken	Ca	215,081	386,419
$ 4,865,613	$ 1,827,581						$ 1,134,387	$ 2,005,102

(1) A break in yield for a given tranche investment means that defaults and/or deferrals have reached such a level that the specific tranche would not receive all of the contractual

principal and interest cash flow by its maturity, resulting in not a temporary shortfall, but an actual loss. This column represents the percentage of additional defaults among the currently performing collateral that would result in other than temporary impairment and loss.

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

The second group consists of one municipal bond with a temporary loss of approximately $1,000. This bond is current and has an A2 rating from Moody s. The Company plans to hold it until maturity in 2021.

The third and fourth group consists of a Community Reinvestment Act qualified investment bond fund with a temporary loss of approximately $1,000, and FHLMC preferred bank stock with a temporary loss of $3,000. Both represent a relatively small balance of the portfolio and the Company plans to hold them indefinitely.

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

		Available for sale
Beginning balance as of December 31, 2009	$	658,734
Add: Amount related to the credit loss for which an other-than- temporary impairment was not previously recognized		100,650
Add: Increases to the amount related to the credit loss for which an other-than temporary impairment was previously recognized		375,003
Less: Realized losses for securities sold		
Less: Securities for which the amount previously recognized in other comprehensive income was recognized in earnings because the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis		
Less: Increases in cash flows expected to be collected that are recognized over the remaining life of the security (See FASB ASC 320-10-35-35)		
Ending balance as of March 31, 2010	$	1,134,387

The carrying value of securities pledged to secure deposits and for other purposes amounted to $20.1 million and $23.7 million at March 31, 2010 and December 31, 2009, respectively.
The amortized cost and fair value of restricted securities follows:

	March 31, 2010			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized (Losses)**	**Fair Value**
Restricted investments:				
Federal Home Loan Bank Stock	$ 3,625,700	$	$	$ 3,625,700
Federal Reserve Bank Stock	99,000			99,000
Community Bankers Bank Stock	50,000			50,000
	$ 3,774,700	$	$	$ 3,774,700

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

The Company s restricted investments include an equity investment in the Federal Home Loan Bank of Atlanta (FHLB). FHLB stock is generally viewed as a long term investment and as a restricted investment which is carried at cost because there is no market for the stock other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on ultimate recoverability of the par value rather than recognizing temporary declines in value. Despite the FHLB s temporary suspension of cash dividends in 2009, the Company does not consider this investment to be other than temporarily impaired at March 31, 2010, and no impairment has been recognized.

Note 3. Loans
A summary of the balances of loans follows:

	March 31, 2010	December 31, 2009
	(Thousands)	
Real estate loans:		
Construction	$ 30,027	$ 33,003
Secured by farmland	1,093	948
Secured by 1 - to - 4 family residential	193,650	193,709
Other real estate loans	192,780	186,463
Commercial and industrial loans (not secured by real estate)	27,941	29,286
Consumer installment loans	13,354	10,390
All other loans	14,105	14,559
Total loans	$ 472,950	$ 468,358
Unearned income	(51)	(92)
Allowance for loan losses	(5,470)	(5,482)
Net loans	$ 467,429	$ 462,784

Of the $192.7 million in other real estate loans at March 31, 2010, $100.2 million or 52.1% were owner occupied. Of the $186.5 million in other real estate loans at December 31, 2009, $100.3 million or 53.8% were owner occupied.

Note 4. Allowance for Loan Losses
Analysis of the allowance for loan losses follows:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009	Twelve Months Ended December 31, 2009
Balance at beginning of year	$ 5,481,963	$ 4,779,662	$ 4,779,662
Provision for loan losses	375,000	200,000	1,710,000
Recoveries of loans previously charged-off	15,370	13,462	81,106
Loan losses charged-off	(402,802)	(120,553)	(1,088,805)
Balance at end of year	$ 5,469,531	$ 4,872,571	$ 5,481,963

Nonperforming assets consist of the following:

(Dollars in thousands)	March 31, 2010	December 31, 2009	March 31, 2009
Non-accrual loans	$ 3,420	$ 3,410	$ 1,573
Restructured loans			

Other real estate owned		2,029		2,480	$	2,029
Other repossessed assets owned		61		54		36
Non-performing corporate bond investments, at fair value		1,828		1,126		
Total nonperforming assets	$	7,338	$	7,070	$	3,638
Allowance for loan losses to total loans, period end		1.16%		1.17%		1.08%
Non-accrual loans to total loans, period end		0.72%		0.73%		0.35%
Allowance for loan losses to non-accrual loans, period end		159.83%		160.76%		309.79%
Non-performing assets to total assets, period end		1.29%		1.24%		0.69%

	March 31, 2010	December 31, 2009	March 31, 2009
Impaired loans for which an allowance has been provided	$ 3,059,542	$ 3,213,516	$ 1,629,725
Impaired loans for which no allowance has been provided	607,256	175,429	228,496
	$ 3,666,798	$ 3,388,945	$ 1,858,221
Allowance provided for impaired loans, included in the allowance for loan losses	$ 1,054,000	$ 1,163,072	$ 776,777

	Three Months Ended March 31, 2010	Twelve Months Ended December 31, 2009	Three Months Ended March 31, 2009
Average balance in impaired loans	$ 3,725,047	$ 3,631,937	$ 1,871,016
Interest income recognized on impaired loans	$ 11,740	$ 148,490	$ 14,757

Total loans past due 90 days or more and still accruing interest were $197,000 at March 31, 2010 and $354,000 and $4,000 on December 31, 2009, and March 31, 2009, respectively.

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.

Note 5. Company-Obligated Mandatorily Redeemable Capital Securities

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

Total capital securities at March 31, 2010 and 2009 were $4,124,000 for both respective dates. The Trust II issuance of capital securities and the respective subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

Note 6. Earnings Per Share

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

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2009	
	Shares	**Per Share Amount**	**Shares**	**Per Share Amount**
Basic earnings per share	3,602,776	$ 0.22	3,535,817	$ 0.26
Effect of dilutive securities, stock-based awards	15,356		18,950	
	3,618,132	$ 0.22	3,554,767	$ 0.26

All shares in circulation were dilutive and included in the calculation above at March 31, 2010. Shares not included in the calculation above because their effects were not dilutive totaled 23,732 at March 31, 2009.

Note 7. Stock-Based Compensation

Stock Incentive Plan (2009)

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

Under the Plan, stock options, stock appreciation rights, non-vested and/or restricted shares, and long-term performance unit awards may be granted to directors and employees for purchase of the Company s stock. The effective date of the plan was March 19, 2009, the date the Company s Board approved the Plan, and 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 employees are generally subject to vesting requirements and are subject to forfeiture if vesting and other contractual provision requirements are not met. The restricted shares for non-executive directors are not subject to vesting requirements, but are generally subject to three year restrictions of sale.

Non employee Director Stock Option Plan

The Company previously has issued stock options to non-employee directors under its Non-employee Director Stock Option Plan, which expired in 1999. Under that plan, each non-employee director of the Company or its subsidiary received an option grant covering 2,240 shares of Company common stock on April 1 of each year during the five-year term of the plan. The first grant under the plan was made on May 1, 1995. The exercise price of awards was fixed at the fair market value of the shares on the date the option was granted. During the term of the plan, a total of 120,960 options for shares of common stock were granted. Effective January 1, 2000, the Omnibus Stock Ownership and Long-Term Incentive Plan for employees was amended and restated to include non-employee directors.

The Company did not grant stock options during the three months ended March 31, 2010 or March 31, 2009.

The Company granted awards of shares to executive officers and non-employee directors under the above-described incentive plans: 9,784 shares and 15,050 shares of unvested restricted stock to executive officers and

5,553 shares and 8,450 shares of restricted stock to non-executive directors on March 5, 2010 and February 18, 2009, respectively.

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 executive 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 non-vested shares amounted to $55,000 and $85,000, net of forfeiture, for the three months ended March 31, 2010 and 2009, respectively. During the quarter ended March 31, 2010, the restricted shares previously issued to non-employee directors were no longer subject to a vesting period, and the previously deferred compensation expense on these shares, totaling an additional compensation expense of $150,000, was fully recognized during the first quarter of 2010.

The Company granted awards of non-vested performance-based stock rights to executive officers of 9,784 share rights and 15,050 share rights of to executive officers on March 5, 2010 and February 18, 2009, respectively.

The performance-based stock rights are accounted for using the fair market value of the Company s common stock on the date the restricted shares were awarded, and adjusted as the market value of the stock changes. The performance-based stock rights shares issued to executive officers and directors are subject to a vesting period, whereby, the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded. They are also subject to the Company reaching a predetermined return on average equity ratio for the final year of the vesting period. Compensation expense for performance-based stock rights amounted to $28,000 and $12,000 during the quarters ended March 31, 2010 and 2009, respectively.

A summary of the status of the options granted under the above described plans is presented below:

	Three Months Ended March 31, 2010		
	Number of Shares	Weighted Average Exercise Price	Average Intrinsic Value (1)
Outstanding at January 1, 2010	62,480	$ 9.96	
Granted			
Exercised	(4,000)	8.10	
Forfeited			
Outstanding at March 31, 2010	58,480	$ 10.09	
Exercisable at end of quarter	58,480		$ 279,168
Weighted-average fair value per option of options granted during the year			

(1) The aggregate intrinsic value of stock options in the table above reflects the pre-tax intrinsic value (the amount by

which the March 31, 2010 market value of the underlying stock option exceeded the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on March 31, 2010. This amount changes based on the changes in the market value of the Company s stock.

The total intrinsic value of options exercised during the three months ended March 31, 2010 and 2009 was $23,900 and $22,478, respectively.

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

	Three Months Ended March 31, 2010	
	Number of Shares	Weighted Average Price
Nonvested at January 1, 2010	47,282	
Granted	15,337	$ 13.78
Vested	(28,847)	
Nonvested at March 31, 2010	33,772	

As of March 31, 2010, there was $265,115 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over an approximate period of 35 months.

Note 8. Employee Benefit Plan

The following table provides a reconciliation of the changes in the defined benefit pension plan s obligations for the three months ended March 31, 2010 and 2009.

	Three Months Ended March 31,	
	2010	**2009**
Service cost	$	$ 62,707
Interest cost	79,523	73,827
Expected return on plan assets	(64,176)	(65,029)
Amortization of transition (asset)		
Amortization of prior service cost		
Recognized net actuarial (gain) loss		
Net periodic benefit cost	$ 15,347	$ 71,505

The Company previously disclosed in its financial statements for the year ended December 31, 2009, that there were no contributions made to its pension plan in 2009. As of March 31, 2010, the pension plan required no additional contributions.

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

Defined benefit pension plan expenses are projected to be approximately $61,000 in 2010 and nothing due to curtailment going forward. Expenses for the 401(k) plan are projected to increase to approximately $625,000 in 2010. Growth in 401(k) expense after 2010 is projected to increase approximately at the same rate of increase as salaries.

Note 9. Fair Value Measurement

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

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

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

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

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

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

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

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2010 and December 31, 2009:

(In Thousands)		Fair Value Measurements at Using		
Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at March 31, 2010 Available-for-sale securities	$ 36,974	$ 35,146	$	$ 1,828
Assets at December 31, 2009 Available-for-sale securities	$ 36,692	$ 34,780	$	$ 1,912

Change in Level 3 Fair Value

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

		Total Gains (Losses) Realized/Unrealized			
	Balance January 1, 2010	Included in earnings	Included in Other Comprehensive Income	Transfers in and/or out of Level 3	Balance March 31, 2010
Available for sale securities	$ 1,912	$ (476)	$ (84)	$ 476	$ 1,828

Certain financial 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:

Loans held for sale: Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the

Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the quarter ended March 31, 2010. Gains and losses on the sale of loans, if applicable, are recorded within income from mortgage banking on the Consolidated Statements of Income.

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

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

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

		Carrying value at March 31, 2010		
(In Thousands)	**Balance as of March 31,**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs**	**Significant Unobservable Inputs**
Description	**2010**		**(Level 2)**	**(Level 3)**
Assets:				
Impaired loans, net	$ 2,006		$ 799	$ 1,207
Other real estate owned	2,029		2,029	

		Carrying value at December 31, 2009		
(In Thousands)	**Balance as of December 31,**	**Quoted Prices in Active Markets for Identical Assets**	**Significant Other Observable Inputs**	**Significant Unobservable Inputs**

Description	**2009**	**(Level 1)**	**(Level 2)**	**(Level 3)**
Assets:				
Impaired loans, net	$ 2,050		$ 794	$ 1,256
Other real estate owned	451		451	

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

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

Cash and cash equivalents

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

Securities

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

Loan Receivables

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Deposit Liabilities

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

Federal Funds Purchased

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

Federal Home Loan Bank Advances

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

Off-Balance-Sheet Financial Instruments

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

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

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

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

	March 31, 2010		December 31, 2009	
(In Thousands)	**Carrying Amount**	**Fair Value**	**Carrying Amount**	**Fair Value**
Financial assets:				
Cash and short-term investments	$ 23,455	$ 23,455	$ 26,199	$ 26,199
Federal funds sold	9	9	9	9
Securities	40,748	40,748	36,692	36,692
Loans, net	467,430	475,807	462,784	477,100
Accrued interest receivable	1,650	1,650	1,495	1,495
Financial liabilities:				
Deposits	$ 467,796	$ 457,656	$ 465,987	$ 467,600
FHLB advances	50,000	50,786	50,000	50,477
Federal funds purchased				
Company obligated mandatorily redeemable capital securities	4,124	2,919	4,124	2,673
Accrued interest payable	623	623	613	613

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

Note 10. 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.

The Company evaluated subsequent events through the date of filing this document. Based on the evaluation, the Company did not identify any recognized or non-recognized subsequent events that would have required adjustment to, or disclosure in, the financial statements.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

For additional discussion of risk factors that may cause our actual future results to differ materially from the results indicated within forward-looking statements, please see Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

GENERAL

Fauquier Bankshares, Inc. (the Company) was incorporated under the laws of the Commonwealth of Virginia on January 13, 1984. The Company is a registered bank holding company and owns all of the voting shares of The Fauquier Bank (the Bank). The Company engages in its business through the Bank, a Virginia state-chartered bank that commenced operations in 1902. The Company has no significant operations other than owning the stock of the Bank. The Company had issued and outstanding 3,620,544 shares of common stock, par value $3.13 per share, held by approximately 420 holders of record on March 31, 2010. The Bank has ten full service branch offices located in the Virginia communities of Old Town-Warrenton, Warrenton, Catlett, The Plains, Sudley Road-Manassas, Old Town-Manassas, New Baltimore, Bealeton, Bristow and Haymarket. The executive offices of the Company and the main office of the Bank are located at 10 Courthouse Square, Warrenton, Virginia 20186.

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

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

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

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

As is the case with banking institutions generally, the Bank s operations are materially and significantly influenced by general economic conditions and by related monetary and fiscal policies of financial institution regulatory agencies, including the Board of Governors of the Federal Reserve System (Federal Reserve). As a Virginia-chartered bank and a member of the Federal Reserve, the Bank is supervised and examined by the Federal Reserve and the Virginia State Corporation Commission. Interest rates on competing investments and general market rates of interest influence deposit flows and costs of funds. Lending activities are affected by the demand for financing of real estate and other types of loans, which in turn is affected by the interest rates at which such financing may be offered and other factors affecting local demand and availability of funds. The Bank faces strong competition in the attraction of deposits (its primary source of lendable funds) and in the origination of loans. Please see Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

As of March 31, 2010, the Company had total consolidated assets of $570.6 million, total loans net of allowance for loan losses of $467.4 million, total consolidated deposits of $467.8 million, and total consolidated shareholders equity of $43.3 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 two basic components: the specific allowance and the general allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance for larger balance, non-homogeneous loans. The specific allowance uses various techniques to arrive at an estimate of loss. First, analysis of the borrower s overall financial condition, resources and payment record, the prospects for support from financial guarantors, and the fair market value of collateral are used to estimate the probability and severity of inherent losses. Then the migration of historical default rates and loss severities, internal risk ratings, industry and market conditions and trends, and other environmental factors are considered. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The general allowance is used for estimating the loss on pools of smaller-balance, homogeneous loans; including 1-4 family mortgage loans, installment loans, other consumer loans, and outstanding loan commitments. Also, the general allowance is used for the remaining pool of larger balance, non-homogeneous loans which were not allocated a specific allowance upon their review. The general allowance begins with estimates of probable losses inherent in the homogeneous portfolio based upon various statistical analyses. These include analysis of historical and peer group delinquency and credit loss experience, together with analyses that reflect current trends and conditions. The Company also considers trends and changes in the volume and term of loans, changes in the credit process and/or lending policies and procedures, and an evaluation of overall credit quality. The general allowance uses a historical loss view as an indicator of future losses. As a result, even though this history is regularly updated with the most recent loss information, it could differ from the loss incurred in the future. The general allowance also captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in the specific allowances.

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 six quarter basis to determine risk profiles for each qualitative factor. Ratings are assigned through a defined matrix to calculate the allowance consistent with authoritative accounting literature. A narrative summary of the reserve allowance is produced quarterly and reported directly to the Company s Board of Directors. The Company s application of these qualitative factors to the allowance for loan losses has been consistent over the reporting period.

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

EXECUTIVE OVERVIEW

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

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

commitment to the community. 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 $804,000 for the first quarter of 2010 was a 12.9% decrease from the net income for the first quarter of 2009 of $923,000. Loans, net of reserve, totaling $467.4 million at March 31, 2010, increased 1.0% when compared with December 31, 2009, and increased 5.4% when compared with March 31, 2009. Deposits, totaling $467.8 million at March 31, 2010, increased 0.4% compared with year-end 2009, and increased 12.4% when compared with March 31, 2009. Assets under WMS management, totaling $309.3 million in market value at March 31, 2010, increased 30.4% from $237.2 million in market value at March 31, 2009, primarily due to the increase in valuations of common stock under management. For example, from March 31, 2009 to March 31, 2010, stocks measured in the Standard & Poors 500 index increased by approximately 47%.

Net interest income is the largest component of net income, and equals the difference between income generated on interest-earning assets and interest expense incurred on interest-bearing liabilities. Future trends regarding net interest income are dependent on the absolute level of market interest rates, the shape of the yield curve, the amount of lost income from non-performing assets, the amount of prepaying loans, the mix and amount of various deposit types, competition for loans and deposits, and many other factors, as well as the overall volume of interest-earning assets. These factors are individually difficult to predict, and when taken together, the uncertainty of future trends compounds. Based on management s current projections, net interest income may increase in 2010 and beyond as average interest-earning assets increase, but this may be offset in part or in whole by a possible contraction in the Bank s net interest margin resulting from competitive market conditions and/or a flat or inverted yield curve. A steeper yield curve is projected to result in an increase in net interest income, while a flatter or inverted yield curve is projected to result in a decrease in net interest income.

The Bank s non-performing assets totaled $7.3 million or 1.29% of total assets at March 31, 2010, as compared with $7.1 million or 1.24% of total assets at December 31, 2009, and $3.6 million or 0.69% of total assets at March 31, 2009. Nonaccrual loans totaled $3.4 million or 0.72% of total loans at March 31, 2010 compared with $3.4 million or 0.73% of total loans at December 31, 2009, and $1.6 million or 0.35% of total loans at March 31, 2009. The provision for loan losses was $375,000 for the first quarter of 2010 compared with $200,000 for the first quarter of 2009. Loan charge-offs, net of recoveries, totaled $387,000 or 0.08% of total average loans for the first three months of 2010, compared with $107,000 or 0.02% of total average loans for the first three months of 2009. The $175,000 increase in the provision for loan losses from first quarter 2009 to first quarter 2010 was largely in response to the increase in net loan charge-offs. Total allowance for loan losses was $5.5 million or 1.16% of total loans at March 31, 2010 compared with $5.5 million or 1.17% of loans at December 31, 2009 and $4.9 million or 1.08% of loans at March 31, 2009.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND MARCH 31, 2009

NET INCOME

Net income of $804,000 for the first quarter of 2010 was a 12.9% decrease from the net income for the first quarter of 2009 of $923,000. Earnings per share on a fully diluted basis were $0.22 for the first three months of 2010 compared to $0.26 for the first three months of 2009. Profitability as measured by return on average assets decreased from 0.72% in the first quarter of 2009 to 0.58% for the same period in 2010. Profitability as measured by return on average equity decreased from 8.89% to 7.48% over the same respective quarters in 2009 and 2010. The decline in net income and the corresponding profitability measures was primarily due to the $476,000 loss on the impairment of the Bank s investment in pooled trust preferred corporate bonds, as well as an increase in non-interest other expenses of $434,000, primarily due to expenses relating to the operations of two new branches that were not in operation in March 2009. This was partially offset by a $564,000 increase in net interest income in the first quarter of 2010 compared with the first quarter of 2009.

NET INTEREST INCOME AND EXPENSE

Net interest income increased $564,000 or 11.4% to $5.50 million for the quarter ended March 31, 2010 from $4.94 million for the quarter ended March 31, 2009. The increase in net interest income was due to the impact of total average earning assets increasing 7.1% from $485.6 million during the first quarter of 2009 to $525.7 million during

the first quarter of 2010. This was partially offset by the Company s net interest margin increasing from 4.12% in the first quarter of 2009 to 4.27% in the first quarter of 2010.

Total interest income increased $261,000 or 3.8% to $7.07 million for the first quarter of 2010 from $6.81 million for the first quarter of 2009. This increase was primarily due to the increase in total average earning assets of $40.2 million from first quarter 2009 to first quarter 2010. This was partially offset by the 21 basis point decrease in the yield on average assets over the same time period.

The average yield on loans was 5.81% for the first quarter of 2010 as well as the first quarter of 2009. Average loan balances increased $24.0 million or 5.4% from $443.2 million during the first quarter of 2009 to $467.2 million during the first quarter of 2010. The increase in loans outstanding and constant yield resulted in a $310,000 or 4.9% increase in interest and fee income from loans for the first quarter of 2010 compared with the same period in 2009.

Average investment security balances increased $3.8 million from $37.6 million in the first quarter of 2009 to $41.4 million in the first quarter of 2010. The tax-equivalent average yield on investments decreased from 4.82% for the first quarter of 2009 to 3.86% for the first quarter of 2010. Together, there was a decrease in interest and dividend income on security investments of $53,000 or 12.6%, from $422,000 for the first quarter of 2009 to $369,000 for the first quarter of 2010. This decrease was partially due to the suspension of interest payments on the Bank s investment in pooled trust-preferred corporate bonds during the first quarter of 2010. Interest income on deposits in other banks increased $4,000 from first quarter 2009 to first quarter 2010.

Total interest expense decreased $303,000 or 19.3% from $1.87 million for the first quarter of 2009 to $1.57 million for the first quarter of 2010 primarily due to the overall decline in shorter-term market interest rates. Interest paid on deposits decreased $283,000 or 18.2% from $1.56 million for the first quarter of 2009 to $1.28 million for the first quarter of 2010. Average money market account balances decreased $12.5 million from first quarter 2009 to first quarter 2010, while their average rate decreased from 0.97% to 0.75% over the same period, resulting in a decrease of $63,000 of interest expense for the first quarter of 2010. Average time deposit balances increased $40.1 million from the first quarter of 2009 to the first quarter of 2010 while the average rate on time deposits decreased from 3.26% to 1.98%, resulting in a decrease of $307,000 in interest expense for the first quarter of 2010. Average NOW deposit balances increased $15.4 million from the first quarter of 2009 to the first quarter of 2010, while the average rate on NOW accounts increased from 0.43% to 0.59%, resulting in an increase of $52,000 in NOW interest expense for the first quarter of 2010.

Interest expense on FHLB of Atlanta advances increased $7,000 from the first quarter of 2009 to the first quarter of 2010 due to the increase in the average rate paid on FHLB advances from 1.79% to 2.19%. Over the last nine months, the Bank has strategically been extending the weighted average maturity of its FHLB advances in order to reduce its exposure to rising interest rates. This has led to the 0.40% increase in rates paid on the FHLB advances for the first quarter of 2010 compared with the same quarter one year earlier. The average rate on total interest-bearing liabilities decreased from 1.86% for the first quarter of 2009 to 1.40% for the first quarter of 2010.

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

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

	Three Months Ended March 31,2010			Three Months Ended March 31, 2009		
	Average Balances	Income/ Expense	Average Rate	Average Balances	Income/ Expense	Average Rate
ASSETS:						
Loans						
Taxable	$ 449,292	$ 6,529	5.82%	$ 433,102	$ 6,285	5.81%
Tax-exempt (1)	14,127	245	6.95%	8,534	145	6.80%
Nonaccrual (2)	3,732			1,531		
Total Loans	467,151	6,774	5.81%	443,167	6,430	5.81%
Securities						
Taxable	35,616	309	3.48%	31,946	361	4.52%
Tax-exempt (1)	5,766	91	6.25%	5,672	93	6.57%
Total securities	41,382	400	3.86%	37,618	454	4.82%
Deposits in banks	17,181	8	0.19%	4,595	4	0.32%
Federal funds sold	9		0.15%	170	0.1	0.26%
Total earning assets	525,723	7,182	5.47%	485,550	6,888	5.68%
Less: Reserve for loan losses	(5,492)			(4,883)		
Cash and due from banks	5,729			7,529		
Bank premises and equipment, net	14,481			8,857		
Other assets	24,978			22,265		
Total Assets	$ 565,419			$ 519,318		
LIABILITIES & SHAREHOLDERS EQUITY:						
Deposits						
Demand deposits	$ 63,722			$ 64,226		

Interest-bearing deposits						
NOW accounts	90,863	133	0.59%	75,465	81	0.43%
Money market accounts	59,331	110	0.75%	71,878	173	0.97%
Savings accounts	48,651	59	0.49%	32,234	25	0.31%
Time deposits	199,572	973	1.98%	159,486	1,280	3.26%
Total interest-bearing deposits	398,417	1,275	1.30%	339,063	1,559	1.86%
Federal funds purchased				4,914	10	0.86%
Federal Home Loan Bank advances	50,000	274	2.19%	59,556	267	1.79%
Capital securities of subsidiary trust	4,124	19	1.87%	4,124	36	3.84%
Total interest-bearing liabilities	452,541	1,568	1.40%	407,656	1,872	1.86%
Other liabilities	5,583			5,346		
Shareholders equity	43,573			42,090		
Total Liabilities & Shareholders Equity	$ 565,419			$ 519,318		
Net interest spread		$ 5,614	4.07%		$ 5,017	3.82%
Interest expense as a percent of average earning assets			1.20%			1.56%
Net interest margin			4.27%			4.12%

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

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

earning assets.

RATE/VOLUME ANALYSIS

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

RATE / VOLUME VARIANCE
(In Thousands)
Three Months Ended March 31, 2010 Compared to
Three Months Ended March 31, 2009

	Change	Due to Volume	Due to Rate
INTEREST INCOME			
Loans; taxable	$ 244	$ 235	9
Loans; tax-exempt (1)	100	95	5
Securities; taxable	(52)	41	(93)
Securities; tax-exempt (1)	(2)	2	(4)
Deposits in banks	4	11	(7)
Federal funds sold			
Total Interest Income	294	384	(90)
INTEREST EXPENSE			
NOW accounts	52	17	35
Money market accounts	(63)	(30)	(33)
Savings accounts	34	13	21
Time deposits	(307)	322	(629)
Federal funds purchased and securities sold under agreements to repurchase	(10)	(10)	
Federal Home Loan Bank advances	7	(43)	50
Capital securities of subsidiary trust	(17)		(17)
Total Interest Expense	(304)	269	(573)
Net Interest Income	$ 598	$ 115	$ 483

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

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

The provision for loan losses was $375,000 for the first quarter of 2010, compared with $200,000 for the first quarter of 2009. The amount of the provision for loan loss was based upon management s continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank s delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. Greater weight is given to the loss history by loan category, prolonged changes in portfolio delinquency trends by loan category, and changes in economic trends. There can be no assurances, however, that future losses will not exceed estimated amounts, or that increased amounts of provisions for loan losses will not be required in future periods.

The $175,000 increase in the provision for loan losses during the first quarter of 2010, compared to the same quarter one year earlier, was largely in response to the increase in total loans and non-accrual loans at March 31, 2010 compared with one year earlier.

OTHER INCOME

Total other income decreased by $172,000 from $1.12 million for the first quarter of 2009 to $952,000 in the first quarter of 2010. Non-interest income is derived primarily from recurring non-interest fee income, which consists primarily of fiduciary and other Wealth Management fees, service charges on deposit accounts, and other fee income. The decline in other income was primarily due to the $476,000 loss on the impairment of the Bank s investment in pooled trust preferred corporate bonds, partially offset by a $89,000 gain on the sale of investments, a $57,000 increase in Wealth Management income, and a $120,000 decrease on the loss realized on the sale of other real estate owned properties.

Wealth Management income increased $57,000 or 23.0% from the first quarter of 2009 to the first quarter of 2010, as assets under management increased from year to year, primarily due to the increase in overall stock market valuations as well as the growth in new customer relationships.

Service charges on deposit accounts increased $15,000 or 2.4% to $621,000 for the first three months of 2010 compared to one year earlier. Due to changes in regulations regarding customer usage of overdraft protection services, service charges on deposit accounts are projected to decline during the second half of 2010. Whether this is a temporary change to customer preferences for overdraft protection, or a more permanent structural change is difficult to determine at this point in time.

Other service charges, commissions and fees increased $23,000 or 5.7% from $403,000 in first quarter 2009 to $426,000 in first quarter 2010. Also included in other service charges, commissions, and income is Bank Owned Life Insurance (BOLI) income, which was $101,000 during the first quarter of 2010 compared with $100,000 one year earlier. Total BOLI was $10.9 million at March 31, 2010, compared with $10.8 million one year earlier.

OTHER EXPENSE

Total other expense increased $434,000 or 9.4% during the first quarter of 2010 compared with the first quarter of 2009. Salaries and employees benefits increased $93,000 or 3.9%, entirely due to a $111,000 increase in the 401(k) plan contribution. This increase is the result of the termination of the Bank s defined-benefit pension plan and enhancement of its defined-contribution 401(k) plan. Active full-time equivalent personnel totaled 161 at March 31, 2010 compared with 147 at March 31, 2009. The increase was primarily due to the staffing of the Bristow and Haymarket offices since the first quarter of 2009.

On December 20, 2007, the Company s Board of Directors approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010 the Board approved to replace the defined benefit pension plan with an enhanced 401(k) plan. Defined benefit pension plan expenses are projected to be approximately $61,000 in 2010, and nothing due to curtailment going forward. Expenses for the 401(k) plan are projected to increase to approximately $625,000 in 2010. Growth in 401(k) expenses after 2010 is projected to increase approximately at the same rate of increase as salaries.

The Bank expects personnel costs, consisting primarily of salary and benefits, to continue to be its largest other expense. As such, the most important factor with regard to potential changes in other expenses is the expansion of staff. The cost of any additional staff expansion, however, would be expected to be offset by the increased revenue generated by the additional services that the new staff would enable the Bank to perform. For the remainder of 2010, the Company plans to add one new full-time position, and will fill four currently vacant positions.

Net occupancy expense increased $193,000 or 62.8%, and furniture and equipment expense increased $37,000 or 13.3%, from first quarter 2009 to first quarter 2010. The increase in occupancy expense and furniture and equipment expense primarily reflect increases in rent, building depreciation, and furniture and equipment depreciation associated with the opening of the Bristow and Haymarket branch offices, and the new location of the Warrenton-View Tree office, none of which were in operation during the first quarter of 2009.

Marketing expense increased $35,000 or 29.3% from $121,000 for the first quarter of 2009 to $156,000 for the first quarter of 2010. This increase primarily reflects the marketing expense of the grand openings of the Haymarket office and relocation of the Warrenton-View Tree office. Marketing expenses for all of 2010 are projected to be approximately the same as 2009.

Legal, accounting and consulting expense decreased $69,000 or 20.5% in the first quarter of 2010 compared with the first quarter of 2009. The decrease of legal fees was associated with the 2009 annual meeting and contested election of directors, which was atypical, and did not reoccur in 2010.

FDIC deposit insurance expense increased 25.9% from $145,000 for the first three months of 2009 to $183,000 for the first three months of 2010. Projections of future FDIC expense are difficult when taking into consideration the possibility of additional special assessments required by the FDIC.

Data processing expense increased $10,000 or 2.8% for the first quarter of 2010 compared with the same time period in 2009. The Bank outsources much of its data processing to a third-party vendor.

Other operating expenses increased $97,000 or 13.9% in the first quarter of 2010 compared with the first quarter of 2009. The increase was primarily due to the acceleration in the vesting of directors restricted stock. For additional information regarding the acceleration in the vesting of directors restricted stock, see Stock-Based Compensation in Note 7 of the Notes to Consolidated Financial Statements contained herein.

INCOME TAXES

Income tax expense was $244,000 for the quarter ended March 31, 2010 compared with $342,000 for the quarter ended March 31, 2009. The effective tax rates were 23.3% and 27.0% for the first quarter of 2010 and 2009, respectively. The effective tax rate differs from the statutory federal income tax rate of 34% due to the Bank s investment in tax-exempt loans and securities, and income from the BOLI purchases.

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

Total assets were $570.6 million at March 31, 2010 compared with $568.5 million at December 31, 2009, an increase of 0.4% or $2.1 million. Balance sheet categories reflecting significant changes included interest-bearing deposits in other banks, total loans, other real estate owned, and deposits. Each of these categories is discussed below.

INTEREST-BEARING DEPOSITS IN OTHER BANKS. Interest-bearing deposits in other banks were $16.5 million at March 31, 2010, reflecting a decrease of $4.1 million from December 31, 2009. The decrease in interest-bearing deposits in other banks was primarily due to the deployment of funds from interest-bearing deposits in other banks into loans.

LOANS. Total net loan balance after allowance for loan losses was $467.4 million at March 31, 2010, which represents an increase of $4.6 million or 1.0% from $462.8 million at December 31, 2009.

OTHER REAL ESTATE OWNED. Other real estate owned declined by $451,000 from December 31, 2009 to $2.0 million at March 31, 2010 due to the sale of one property at a loss of $16,000. The loss was reflected in the consolidated statement of income for the quarter ended March 31, 2010.

DEPOSITS. For the three months ended March 31, 2010, total deposits increased by $1.8 million or 0.4% when compared with total deposits at December 31, 2009. Non-interest-bearing deposits decreased by $3.6 million and interest-bearing deposits increased by $5.4 million. Included in interest-bearing deposits at March 31, 2010 and December 31, 2009 were $43.6 million and $57.3 million, respectively of brokered deposits as defined by the Federal Reserve. Of the $43.6 million in brokered deposits, $22.6 million represent deposits of Bank customers, exchanged through the CDAR s network. With the CDAR s program, funds are placed into certificates of deposit issued by other banks in the network, in increments of less than $250,000, to ensure both principal and interest are eligible for complete FDIC coverage. These deposits are exchanged with other member banks on a dollar-for-dollar basis, bringing the full amount of our customers deposits back to the bank and making these funds fully available for lending in our community. The decline in the Bank s non-interest-bearing deposits and the increase in interest-bearing deposits during the first three months of 2010 were the result of many factors difficult to segregate and quantify, and equally difficult to use as factors for future projections. The economy, local competition, retail customer preferences, changes in seasonal cash flows by both commercial and retail customers, changes in business cash management practices by Bank customers, the relative pricing from wholesale funding sources, and the Bank s funding needs all contributed to the change in deposit balances. The Bank projects to increase its transaction accounts and other deposits in 2010 and beyond through the expansion of its branch network, as well as by offering value-added NOW and demand deposit products, and selective rate premiums on its interest-bearing deposits.

ASSET QUALITY

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

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

Non-performing assets totaled $7.3 million or 1.29% of total assets at March 31, 2010, compared with $7.1 million or 1.24% of total assets at December 31, 2009, and $3.6 million, or 0.69% of total assets at March 31, 2009. Included in non-performing assets at March 31, 2010 were $1.8 million of non-performing pooled trust preferred bonds at market value, $2.0 million of other real estate owned and $3.4 million of non-accrual loans. Non-accrual loans as a percentage of total loans were 0.72% at March 31, 2010, as compared with 0.73% and 0.35% at December 31, 2009 and March 31, 2009, respectfully.

There were three loans, totaling $197,000, past due 90 days or more and still accruing interest at March 31, 2010 compared with $354,000 and $4,000 on December 31, 2009 and March 31, 2009, respectively. There are no loans or securities, other than those disclosed above as either non-performing or impaired, where information known about the borrower has caused management to have serious doubts about the borrower s ability to repay.

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

Age Analysis of Past Due Financing Receivables
(In thousands)

At March 31, 2010

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Total Loans	Past due as Percentage of Loans
Secured by real estate:						
Construction	$	$	$	$	$ 30,027	0.00%
Farmland					1,093	0.00%
1-4 Family Residential	2,890	505	238	3,633	193,634	1.88%
Commercial Real Estate	500		2,177	2,677	192,731	1.39%
Commercial and Industrial	837	47	593	1,477	27,989	5.28%
Consumer	172	18	99	289	13,353	2.16%
Other					14,123	0.00%
Total	$ 4,399	$ 570	$ 3,107	$ 8,076	$ 472,950	1.71%

At December 31, 2009

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Total Loans	Past due as Percentage of Loans
Secured by real estate:						
Construction	$	$	$	$	$ 33,003	0.00%
Farmland					948	0.00%
1-4 Family Residential	1,978	469	432	2,879	193,709	1.49%
Commercial Real Estate	354	123	1,720	2,197	186,463	1.18%
Commercial and Industrial	781	168	764	1,713	29,286	5.85%
Consumer	137	30	41	208	10,390	2.00%
Other					14,559	0.00%
Total	$ 3,250	$ 790	$ 2,957	$ 6,997	$ 468,358	1.49%

At March 31, 2009

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Total Loans	Past due as Percentage of Loans
Secured by real estate:						
Construction	$	$	$	$	$ 41,313	0.00%
Farmland					1,281	0.00%
1-4 Family Residential	753	576	460	1,789	180,921	0.99%
Commercial Real Estate		1,470		1,470	165,942	0.89%
Commercial and Industrial	1,886	507	228	2,621	35,128	7.46%
Consumer	181	25	127	333	14,255	2.34%
Other					10,016	0.00%
Total	$ 2,820	$ 2,578	$ 815	$ 6,213	$ 448,856	1.38%

At March 31, 2010, no concentration of loans to commercial borrowers engaged in similar activities exceeded 10% of total loans. The largest industry concentration at March 31, 2010 was approximately 5.0% of loans to the hospitality industry (hotels, motels, inns, etc.). For more information regarding the Bank s concentration of loans collateralized by real estate, please refer to the discussion under Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2009 entitled The Company has a high concentration of loans secured by both residential and commercial real estate and a downturn in either or both markets, for any reason, may continue to increase the Company s credit losses, which would negatively affect our financial results.

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 construction and land loans and (b) 300% for permanent investor real estate loans. As of March 31, 2010, construction and land loans were $31.1 million or 53.5% of the concentration limit. Commercial real estate loans, including construction and land loans, were $124.8 million or 214.3% of the concentration level.

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

CONTRACTUAL OBLIGATIONS

As of March 31, 2010, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in Management s Discussion and Analysis in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

OFF-BALANCE SHEET ARRANGEMENTS

As of March 31, 2010, there have been no material changes to the off-balance sheet arrangements disclosed in Management s Discussion and Analysis in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

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 March 31, 2010, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

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

RISK BASED CAPITAL RATIOS
(Dollars in Thousands)

	March 31, 2010	December 31, 2009
Tier 1 Capital:		
Shareholders Equity	$ 43,342	$ 42,639
Plus: Unrealized loss on securities available for sale/defined benefit retirement obligations, net	1,625	1,923
Less: Unrealized loss on equity securities, net	(3)	(4)
Plus: Company-obligated madatorily redeemable capital securities	4,000	4,000
Total Tier 1 Capital	48,964	48,558
Tier 2 Capital:		
Allowable Allowance for Loan Losses	5,470	5,485
Total Capital:	54,434	54,043
Risk Weighted Assets:	$ 448,976	$ 442,658
Regulatory Capital Ratios:		
Leverage Ratio	8.66%	8.68%
Tier 1 to Risk Weighted Assets	10.91%	10.97%
Total Capital to Risk Weighted Assets	12.12%	12.21%

CAPITAL RESOURCES AND LIQUIDITY

Shareholders equity totaled $43.3 million at March 31, 2010 compared with $42.6 million at December 31, 2009 and $40.8 million at March 31, 2009. The amount of equity reflects management s desire to increase shareholders return on equity while maintaining a strong capital base. The Company initiated an open market stock buyback program in 1998, but did not repurchase any shares during the first three months of 2010 and 2009, respectively.

Accumulated other comprehensive income/loss decreased to an unrealized loss net of tax benefit of $1.6 million at March 31, 2010 compared with $1.9 million at December 31, 2009. The decline in the magnitude of the accumulated other comprehensive loss was primarily attributable to the realization of an other-than temporary impairment loss of $476,000 on pooled trust preferred investment securities held available for sale.

As discussed in Company-obligated Mandatorily Redeemable Capital Securities of Subsidiary Trust in Note 5 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 March 31, 2010, 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 of

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

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled $23.5 million at March 31, 2010 compared with $26.2 million at December 31, 2009. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available of sale, of which approximately $14.3 million was unpledged and readily salable at March 31, 2010. Furthermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately $122.2 million at March 31, 2010 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 $69.6 million. At March 31, 2010, $50.0 million of the FHLB of Atlanta line of credit and none of federal funds purchased lines of credit were in use.

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

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

LIQUIDITY SOURCES AND USES
(Dollars in Thousands)

	March 31, 2010			December 31, 2009		
	Total	**In Use**	**Available**	**Total**	**In Use**	**Available**
Sources:						
Federal funds borrowing lines of credit	$ 69,562	$	$ 69,562	$ 72,563	$	$ 72,563
Federal Home Loan Bank advances	122,222	50,000	72,222	108,310	50,000	58,310
Federal funds sold and interest-bearing deposits in other banks, excluding requirements			7,799			13,617
Securities, available for sale and unpledged at fair value			14,271			10,730
Total short-term funding sources			$ 163,854			$ 155,220
Uses:						
Unfunded loan commitments and lending lines of credit			$ 76,584			$ 71,523
Letters of credit			6,558			8,585
Total potential short-term funding uses			$ 83,142			$ 80,108

Ratio of short-term funding sources to potential short-term funding uses	197.1%	193.8%

IMPACT OF INFLATION AND CHANGING PRICES

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

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, 2009.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

As of March 31, 2010, management has assessed the effectiveness of the internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the assessment, management determined that it maintained effective internal control over the financial reporting as of March 31, 2010, based on those criteria, and the Company s Chief Executive Officer and Chief Financial Officer can provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America.

Smith Elliott Kearns & Company, LLC, the independent registered public accounting firm that audited the Company s consolidated financial statements included in the Company s Annual Report on 10-K for the year ended December 31, 2009, has issued an audit report on the Company s effectiveness of internal control over financial reporting as of December 31, 2009. The auditor s report is incorporated for reference in the Company s Annual Report on 10-K for the year ended December 31, 2009 in Item 8 under the heading Report of Independent Public Accounting Firm.

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

PART II, OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors faced by the Company from those disclosed in Company s Annual Report on Form 10-K for the year ended December 31, 2009.

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

None. On January 21, 2010, the Board authorized the Company to repurchase up to 107,840 shares (3% of common stock outstanding on January 1, 2010) beginning January 1, 2010. No shares were repurchased during the first quarter ended March 31, 2010.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

Exhibit Number	**Exhibit Description**
3.1	Articles of Incorporation of Fauquier Bankshares, Inc., as amended, incorporated by reference to Exhibit 3.1 to Form 10-K filed March 15, 2010.
3.2	Bylaws of Fauquier Bankshares, Inc., as amended and restated, incorporated by reference to Exhibit 3.2 to Form 8-K filed November 15, 2007.

Exhibit Number	Exhibit Description
31.1	Certification of CEO pursuant to Rule 13a-14(a).
31.2	Certification of CFO pursuant to Rule 13a-14(a).
32.1	Certification of CEO pursuant to 18 U.S.C. Section 1350.
32.2	Certification of CFO pursuant to 18 U.S.C. Section 1350.

SIGNATURES

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

FAUQUIER BANKSHARES, INC.
(Registrant)

/s/ Randy K. Ferrell
Randy K. Ferrell
President & Chief Executive Officer
Dated: May 10, 2010

/s/ Eric P. Graap
Eric P. Graap
Executive Vice President & Chief
Financial Officer
Dated: May 10, 2010