

FAUQUIER BANKSHARES, INC.

Form 10-Q

May 09, 2008

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

(Mark One)

☒ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2008**

**or**

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

**Commission File No.: 000-25805**

**Fauquier Bankshares, Inc.**

(Exact name of registrant as specified in its charter)

**Virginia**

(State or other jurisdiction of  
incorporation or organization)

**54-1288193**

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

**10 Courthouse Square, Warrenton, Virginia**

(Address of principal executive offices)

**20186**

(Zip Code)

**(540) 347-2700**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting company ☐  
(Do not check if a smaller reporting company)

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

The registrant had 3,572,138 shares of common stock outstanding as of May 5, 2008.

**FAUQUIER BANKSHARES, INC.**  
**INDEX**

Part I. FINANCIAL INFORMATION	Page 3
Item 1. Financial Statements	3
Consolidated Balance Sheets as of March 31, 2008 (unaudited) and December 31, 2007	3
Consolidated Statements of Income (unaudited) for the Three Months Ended March 31, 2008 and 2007	4
Consolidated Statements of Changes in Shareholders' Equity (unaudited) for the Three Months Ended March 31, 2008 and 2007	5
Consolidated Statements of Cash Flows (unaudited) for the Three Months Ended March 31, 2008 and 2007	6
Notes to Consolidated Financial Statements	7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3. Quantitative and Qualitative Disclosures About Market Risk	28
Item 4. Controls and Procedures	28
Part II. OTHER INFORMATION	29
Item 1. Legal Proceedings	29
Item 1A. Risk Factors	29
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	29
Item 3. Defaults Upon Senior Securities	30
Item 4. Submission of Matters to a Vote of Security Holders	30
Item 5. Other Information	30
Item 6. Exhibits	31
SIGNATURES	32

**Part I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

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

	<b>March 31, 2008</b>	<b>December 31, 2007</b>
<b>Assets</b>		
Cash and due from banks	\$ 13,896,065	\$ 16,708,922
Interest-bearing deposits in other banks	927,538	823,252
Federal funds sold		2,020,000
Securities available for sale	38,933,766	37,376,725
Loans, net of allowance for loan losses of \$4,195,964 in 2008 and \$4,185,209 in 2007	411,972,476	409,107,482
Bank premises and equipment, net	8,618,887	7,180,369
Accrued interest receivable	1,549,528	1,748,546
Other assets	14,594,512	14,930,932
<b>Total assets</b>	<b>\$ 490,492,772</b>	<b>\$ 489,896,228</b>
<b>Liabilities and Shareholders' Equity</b>		
Deposits:		
Noninterest-bearing	63,332,308	76,080,935
Interest-bearing	326,774,501	328,477,988
<b>Total deposits</b>	<b>390,106,809</b>	<b>404,558,923</b>
Federal funds purchased	5,000,000	
Federal Home Loan Bank advances	45,000,000	35,000,000
Company-obligated mandatorily redeemable capital securities	4,124,000	4,124,000
Other liabilities	3,807,878	4,385,553
Commitments and Contingencies		
<b>Total liabilities</b>	<b>448,038,687</b>	<b>448,068,476</b>
<b>Shareholders' Equity</b>		
Common stock, par value, \$3.13; authorized 8,000,000 shares: issued and outstanding, 2008: 3,572,728 shares (includes nonvested shares of 40,555); 2007: 3,537,354 shares (includes nonvested shares of 31,190)	11,055,702	10,974,293
Retained earnings	32,008,085	31,626,627
Accumulated other comprehensive income (loss), net	(609,702)	(773,168)
<b>Total shareholders' equity</b>	<b>42,454,085</b>	<b>41,827,752</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 490,492,772</b>	<b>\$ 489,896,228</b>

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**  
**Consolidated Statements of Income**  
**For the Three Months in the Period Ended March 31,**

	<b>2008</b>	<b>2007</b>
<b>Interest Income</b>		
Interest and fees on loans	\$ 6,798,599	\$ 7,278,505
Interest and dividends on securities available for sale:		
Taxable interest income	327,506	372,005
Interest income exempt from federal income taxes	58,224	13,197
Dividends	53,002	50,497
Interest on federal funds sold	28,841	42,600
Interest on deposits in other banks	8,058	4,790
 Total interest income	 7,274,230	 7,761,594
 <b>Interest Expense</b>		
Interest on deposits	2,074,210	2,418,627
Interest on federal funds purchased	33,487	86,843
Interest on Federal Home Loan Bank advances	412,037	524,948
Distribution on capital securities of subsidiary trusts	64,242	156,101
 Total interest expense	 2,583,976	 3,186,519
 Net interest income	 4,690,254	 4,575,075
 Provision for loan losses	 456,000	 120,000
 Net interest income after provision for loan losses	 4,234,254	 4,455,075
 <b>Other Income</b>		
Wealth management income	343,416	338,873
Service charges on deposit accounts	708,597	659,791
Other service charges, commissions and income	428,981	424,138
Gain on sale of securities	87,585	
 Total other income	 1,568,579	 1,422,802
 <b>Other Expenses</b>		
Salaries and benefits	2,328,224	2,348,233
Net occupancy expense of premises	282,395	268,106
Furniture and equipment	286,507	287,600
Marketing expense	169,742	120,401
Consulting expense	280,681	239,942

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

Data processing expense	332,645	299,681
Other operating expenses	715,400	625,216
Total other expenses	4,395,594	4,189,179
Income before income taxes	1,407,239	1,688,698
Income tax expense	398,733	516,218
Net Income	\$ 1,008,506	\$ 1,172,480
<b>Earnings per Share</b> , basic	\$ 0.29	\$ 0.33
<b>Earnings per Share</b> , assuming dilution	\$ 0.28	\$ 0.33
<b>Dividends per Share</b>	\$ 0.20	\$ 0.19

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**For the Three Months March 31, 2008 and 2007**

	Common	Retained	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
	Stock	Earnings			
<b>Balance, December 31, 2006 as restated</b>	\$ 10,789,521	\$ 28,962,409	\$ (1,217,318)		\$ 38,534,612
Comprehensive income:					
Net income		1,172,480		\$ 1,172,480	1,172,480
Other comprehensive income net of tax:					
Unrealized holding gains on securities available for sale, net of deferred income taxes \$55,318			107,382	107,382	107,382
Total comprehensive income				\$ 1,279,862	
Cash dividends (\$.19 per share)		(671,751)			(671,751)
Acquisition of 2,435 shares of common stock	(7,622)	(54,505)			(62,127)
Amortization of unearned compensation, restricted stock awards		62,595			62,595
Issuance of common stock nonvested shares (11,437 shares)	35,797	(35,797)			
Exercise of stock options	178,942	291,917			470,859
<b>Balance, March 31, 2007</b>	\$ 10,996,638	\$ 29,727,348	\$ (1,109,936)		\$ 39,614,050
<b>Balance, December 31, 2007</b>	\$ 10,974,293	\$ 31,626,627	\$ (773,168)		\$ 41,827,752
Comprehensive income:		1,008,506		\$ 1,008,506	1,008,506
Net income					
Other comprehensive income net of tax:					
Unrealized holding gains on securities available for sale, net of deferred income taxes \$113,989			221,272	221,272	
Less: reclassification adjustments, net of tax benefit of \$29,779			(57,806)	(57,806)	



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

Other comprehensive income net of tax of \$84,210			163,466	163,466
Total comprehensive income			1,171,972	
Effects of changing pension plan measurement date, pursuant to FAS158, net of deferred income tax benefit of \$12,437		(24,144)		(24,144)
Initial implementation of EITF 06-4, net of income tax benefit of \$6,433		(12,487)		(12,487)
Cash dividends (\$.20 per share)		(713,662)		(713,662)
Acquisition of 2,680 shares of common stock	(8,388)	(37,515)		(45,903)
Amortization of unearned compensation, restricted stock awards		77,012		77,012
Restricted stock forfeiture		(13,971)		(13,971)
Issuance of common stock nonvested shares (9,763 shares)	30,558	(30,558)		
Exercise of stock options	59,239	128,277		187,516
<b>Balance, March 31, 2008</b>	<b>\$ 11,055,702</b>	<b>\$ 32,008,085</b>	<b>\$ (609,702)</b>	<b>\$ 42,454,085</b>

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**For the Three Months Ended March 31, 2008 and 2007**

	<b>2008</b>	<b>2007</b>
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 1,008,506	\$ 1,172,480
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	234,083	259,195
Provision for loan losses	456,000	120,000
Gain on sale of securities		(87,585)
Amortization (accretion) of security premiums, net	32,498	2,797
Amortization of unearned compensation, net of forfeiture	63,041	62,595
Changes in assets and liabilities:		
Decrease in other assets	468,532	799,130
(Decrease) in other liabilities	(633,176)	(455,285)
Net cash provided by operating activities	1,541,899	1,960,912
<b>Cash Flows from Investing Activities</b>		
Proceeds from sale of securities available for sale	9,078,470	
Proceeds from maturities, calls and principal payments of securities available for sale	1,057,190	987,117
Purchase of securities available for sale	(10,996,072)	
Purchase of premises and equipment	(1,672,601)	(89,527)
(Purchase of) proceeds from sale of other bank stock	(392,300)	563,500
Net (increase) decrease in loans	(3,320,994)	4,497,470
Net cash provided by (used in) investing activities	(6,246,307)	5,958,560
<b>Cash Flows from Financing Activities</b>		
Net (decrease) increase in demand deposits, NOW accounts and savings accounts	(12,977,334)	(691,634)
Net (decrease) increase in certificates of deposit	(1,474,780)	(11,853,290)
Federal Home Loan Bank advances	20,000,000	25,000,000
Federal Home Loan Bank principal repayments	(10,000,000)	(37,000,000)
Purchase (repayment) of federal funds	5,000,000	14,000,000
Repayment of trust preferred securities		(4,124,000)
Cash dividends paid on common stock	(713,662)	
Issuance of common stock	187,516	470,859
Acquisition of common stock	(45,903)	(62,127)
Net cash used in financing activities	(24,163)	(14,260,192)
(Decrease) in cash and cash equivalents	(4,728,571)	(6,340,720)

**Cash and Cash Equivalents**

Beginning	19,552,174	41,679,655
Ending	\$ 14,823,603	\$ 35,338,935

**Supplemental Disclosures of Cash Flow Information**

Cash payments for:		
Interest	\$ 2,723,453	\$ 2,436,421
Income taxes	\$	\$

**Supplemental Disclosures of Noncash Investing Activities**

Unrealized gain (loss) on securities available for sale, net of tax effect	\$ 163,466	\$ 107,382
FAS 158 change in pension plan measurement dates, net of tax effect	\$ (24,144)	\$
Implementation of EITF 06-4, net of tax effect	\$ (12,487)	\$

See accompanying Notes to Consolidated Financial Statements.

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

**Note 1. General**

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

The results of operations for the three months ended March 31, 2008 are not necessarily indicative of the results expected for the full year.

**Note 2. Securities**

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

	<b>March 31, 2008</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized (Losses)</b>	<b>Fair Value</b>
Obligations of U.S. Government corporations and agencies	\$ 23,992,633	\$ 406,765	\$	\$ 24,399,398
Obligations of states and political subdivisions	5,294,158	148,223	(6,500)	5,435,881
Corporate Bonds	6,000,000		(700,000)	5,300,000
Mutual Funds	294,668		(3,901)	290,767
FHLMC Preferred Bank Stock	441,000		(101,000)	340,000
Restricted investments:				
Federal Home Loan Bank Stock	2,905,800			2,905,800
Federal Reserve Bank Stock	99,000			99,000
Community Bankers Bank Stock	50,000			50,000
The Bankers Bank Stock	112,920			112,920
	\$ 39,190,179	\$ 554,988	\$ (811,401)	\$ 38,933,766

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

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

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

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

	<b>March 31, 2008</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>
Due in one year or less	\$ 27,237	\$ 27,401
Due after one year through five years	1,242,618	1,253,025
Due after five years through ten years	4,706,196	4,779,688
Due after ten years	29,310,740	29,075,165
Equity securities	3,903,388	3,798,487
	<b>\$ 39,190,179</b>	<b>\$ 38,933,766</b>

For the quarter ended March 31, 2008, gross realized gains from sales of securities available for sale amounted to \$87,585. The proceeds from the sale of these securities, including the realized gain, amounted to \$9.1 million. The tax expense applicable to this net realized gain amounted to \$29,779. There were no securities sold in the quarter ended March 31, 2007.

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

<b>March 31, 2008</b>	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
<b>Description of Securities</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>
Obligations of U.S. Government, corporations and agencies	\$	\$	\$	\$	\$	\$
Obligations of states and political subdivisions	403,739	(6,500)			403,739	(6,500)
Corporate Bonds	3,532,500	(467,500)	1,767,500	(232,500)	5,300,000	(700,000)
Subtotal, debt securities	3,936,239	(474,000)	1,767,500	(232,500)	5,703,739	(706,500)
Mutual Funds			290,767	(3,901)	290,767	(3,901)
FHLMC Preferred Bank Stock	340,000	(101,000)			340,000	(101,000)
Total temporary impaired securities	\$ 4,276,239	\$ (575,000)	\$ 2,058,267	\$ (236,401)	\$ 6,334,506	\$ (811,401)

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

and agencies

Obligations of states and political subdivisions	899,333	(3,948)			899,333	(3,948)
Corporate Bonds	3,770,000	(230,000)	1,881,250	(118,750)	5,651,250	(348,750)
Subtotal, debt securities	4,669,333	(233,948)	19,679,407	(281,097)	24,348,740	(515,045)
Mutual Funds			291,581	(5,791)	291,581	(5,791)
FHLMC Preferred Bank Stock	344,000	(97,000)			344,000	(97,000)
Total temporary impaired securities	\$ 5,013,333	\$ (330,948)	\$ 19,970,988	\$ (286,888)	\$ 24,984,321	\$ (617,836)

The nature of securities which are temporarily impaired for a continuous 12 month period or more at March 31, 2008 can be segregated into two groups:

The first group consists of corporate bonds, rated A2 by Moody's, totaling \$1.8 million with a temporary loss of approximately \$233,000. These bonds have an estimated maturity of 26 years, but can be called at par on the five year anniversary, which will occur in 2008 and 2009. If not called, the bonds reprice every three months at a fixed rate index above the three-month London Interbank Offered Rate (LIBOR). The Company has the ability to hold these bonds to maturity.

The second group consists of a Community Reinvestment Act qualified investment bond fund with a temporary loss of approximately \$4,000. The fund is a relatively small segment of the portfolio and the Company plans to hold it indefinitely.

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$6,396,941 and \$13,565,758 at March 31, 2008 and December 31, 2007, respectively.

### Note 3. Loans

A summary of the balances of loans follows:

	March 31, 2008	December 31, 2007
	(Thousands)	
Real estate loans:		
Construction	\$ 37,770	\$ 37,204
Secured by farmland	1,853	1,365
Secured by 1 - to - 4 family residential	171,999	170,983
Other real estate loans	134,143	132,918
Commercial and industrial loans (not secured by real estate)	38,147	38,203
Consumer installment loans	21,424	24,133
All other loans	11,170	8,824
Total loans	\$ 416,506	\$ 413,630
Unearned income	(338)	(338)
Allowance for loan losses	(4,196)	(4,185)
Net loans	\$ 411,972	\$ 409,107

### Note 4. Allowance for Loan Losses

Analysis of the allowance for loan losses follows:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Twelve Months Ended December 31, 2007
Balance at beginning of year	\$ 4,185,209	\$ 4,470,533	\$ 4,470,533
Provision for loan losses	456,000	120,000	717,000
Recoveries of loans previously charged-off	23,382	7,707	60,616
Loan losses charged-off	(468,627)	(79,362)	(1,062,940)
Balance at end of year	\$ 4,195,964	\$ 4,518,878	\$ 4,185,209



Nonperforming assets consist of the following:

<b>(Dollars in thousands)</b>	<b>March 31, 2008</b>	<b>December 31, 2007</b>	<b>March 31, 2007</b>
Nonaccrual loans	\$ 1,961	\$ 1,906	\$ 1,629
Restructured loans			
Total nonperforming loans	\$ 1,961	\$ 1,906	\$ 1,629
Foreclosed property	64	222	135
Total nonperforming assets	\$ 2,025	\$ 2,128	\$ 1,764

	<b>March 31, 2008</b>	<b>December 31, 2007</b>
Impaired loans for which an allowance has been provided	\$ 2,966,225	\$ 2,688,501
Impaired loans for which no allowance has been provided	1,103,215	1,247,461
	\$ 4,069,440	\$ 3,935,962
Allowance provided for impaired loans, included in the allowance for loan losses	\$ 1,351,098	\$ 1,392,236
	<b>For the Quarter March 31, 2008</b>	<b>For the Year December 31, 2007</b>
Average balance in impaired loans	\$ 3,962,818	\$ 4,359,817
Interest income recognized on impaired loans	\$ 34,119	\$ 261,257

Total loans past due 90 days or more and still accruing interest totaled \$2.0 million, \$770,000, and \$70,000 on March 31, 2008, December 31, 2007, and March 31, 2007, respectively. The \$2.0 million past due 90 days or more and still accruing at March 31, 2008 consisted of two loans to one borrower collateralized by property under contract for sale scheduled to close during the second quarter of 2008. The proceeds from the sale are adequate to repay all outstanding principal, interest and fees on the two loans.

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

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

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

On March 26, 2002, the Company established a subsidiary trust that issued \$4.0 million of capital securities as part of a pooled trust preferred security offering with other financial institutions (Trust I). The Company used the offering proceeds for the purposes of expansion and the repurchase of additional shares of its common stock. The interest rate on the capital security resets every three months at 3.60% above the then current three month LIBOR. Interest is paid quarterly. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve's capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital.

On September 21, 2006, the Company's wholly-owned Connecticut statutory business trust privately issued \$4 million face amount of the trust's Floating Rate Capital Securities in a pooled capital securities offering (Trust II).

Simultaneously, the trust used the proceeds of that sale to purchase \$4.0 million principal amount of the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. The interest rate on the capital security resets every three months at 1.70% above the then current three month LIBOR. Interest is paid quarterly.

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

Total capital securities at March 31, 2008 and 2007 were \$4,124,000 for both respective dates. The Trust II issuance of capital securities and the respective subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

**Note 6. Earnings Per Share**

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

	<b>Three Months Ended March 31, 2008</b>		<b>Three Months Ended March 31, 2007</b>	
	<b>Shares</b>	<b>Per Share Amount</b>	<b>Shares</b>	<b>Per Share Amount</b>
Basic earnings per share	3,515,475	\$ 0.287	3,522,550	\$ 0.333
Effect of dilutive securities, stock-based awards	36,451		72,603	
	3,551,926	\$ 0.284	3,595,153	\$ 0.326

**Note 7. Stock-Based Compensation**

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

The nonvested shares are accounted for using the fair market value of the Company's common stock on the date the restricted shares were awarded. The restricted shares issued to executive officers and directors are subject to a vesting period, whereby, the restrictions on one-third of the shares lapse on the anniversary of the date the restricted shares were awarded over the next three years. Compensation expense for nonvested shares amounted to \$63,041 and \$62,595 for the three months ended March 31, 2008 and 2007, respectively.

The Company did not grant options during the three months ended March 31, 2008 and 2007.

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

	<b>Three Months Ended March 31, 2008</b>		
	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Average Intrinsic Value (1)</b>
Outstanding at January 1	96,100	\$ 9.85	
Granted			
Exercised	(18,920)	9.91	
Forfeited			
Outstanding at March 31,	77,180	\$ 9.84	\$ 630,150
Exercisable at end of quarter	77,180	\$ 9.84	\$ 630,150

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, 2008 market value of the underlying stock option exceeded the exercise price of the option) that

would have  
been received  
by the option  
holders had all  
option holders  
exercised their  
options on  
March 31, 2008.

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

The total intrinsic value of options exercised during the three months ended March 31, 2008 and 2007 was \$132,774 and \$981,129, respectively.

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

	<b>Three Months Ended March 31, 2008</b>	
	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
Nonvested at January 1, 2008	31,190	
Granted	19,692	\$ 17.70
Vested	(9,769)	
Forfeited, nonvested	(276)	
Forfeited, vested	(282)	\$ 24.84
Novested at March 31, 2008	40,555	

As of March 31, 2008, there was \$570,206 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over an approximate period of three years.

**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, 2008 and 2007.

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
Service cost	\$ 111,081	\$ 167,680
Interest cost	77,352	100,343
Expected return on plan assets	(149,050)	(111,378)
Amortization of transition (asset)	(4,745)	1,942
Amortization of prior service cost	1,942	(4,745)
Recognized net actuarial loss		5,258
Net periodic benefit cost	\$ 36,580	\$ 159,100

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

On December 20, 2007, the Company's Board of Directors approved the termination of the defined benefit pension plan effective on December 31, 2009, and effective January 1, 2010, the Company will replace the defined benefit pension plan with an enhanced 401(k) plan. Defined benefit pension plan expenses are projected to decrease from \$636,000 in 2007 to approximately \$150,000 in 2008 and \$0 in 2009 and going forward. Expenses for the 401(k) plan are projected to increase from \$134,000 in 2007 to approximately \$140,000 in 2008 and 2009, and approximately \$625,000 in 2010. Growth in 401(k) after 2010 is projected to increase approximately at the same rate of increase as salaries.

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

### **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

In addition to the historical information contained herein, this report contains forward-looking statements.

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

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

### **GENERAL**

Fauquier Bankshares, Inc. (the Company) was incorporated under the laws of the Commonwealth of Virginia on January 13, 1984. The Company is a registered bank holding company and owns all of the voting shares of The Fauquier Bank (the Bank). The Company engages in its business through the Bank, a Virginia state-chartered bank that commenced operations in 1902. The Company has no significant operations other than owning the stock of the Bank. The Company had issued and outstanding 3,572,728 shares of common stock, par value \$3.13 per share, held by approximately 434 holders of record on March 31, 2008. The Bank has eight full service branch offices located in the Virginia communities of Warrenton, Catlett, The Plains, Sudley Road-Manassas, Old Town-Manassas, New Baltimore and Bealeton. The executive offices of the Company and the main office of the Bank are located at 10 Courthouse Square, Warrenton, Virginia 20186. The Bank has leased properties in Haymarket, Virginia and Bristow, Virginia, where it plans to build its ninth and tenth full-service branch offices, respectively, scheduled to open during 2009.

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

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

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

The Bank, through its subsidiary Fauquier Bank Services, Inc., has equity ownership interests in Bankers Insurance, LLC, a Virginia independent insurance company; Bankers Investments Group, LLC, a full service broker/dealer; and Bankers Title Shenandoah, LLC, a title insurance company. Bankers Insurance consists of a consortium of 38 Virginia community bank owners; Bankers Investments Group is owned by 34 Virginia and Maryland community banks; and Bankers Title Shenandoah is owned by 10 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 ( SCC ). 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 this report and the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

As of March 31, 2008, the Company had total consolidated assets of \$490.5 million, total loans net of allowance for loan losses of \$412.0 million, total consolidated deposits of \$390.1 million, and total consolidated shareholders' equity of \$42.5 million.

#### **CRITICAL ACCOUNTING POLICIES**

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

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

The Company's allowance for loan losses has two basic components: the specific allowance and the general allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance for larger balance, non-homogeneous loans. The specific allowance uses various techniques to arrive at an estimate of loss. First, analysis of the borrower's overall financial condition, resources and payment record, the prospects for support from financial guarantors, and the fair market value of collateral are used to estimate the probability and severity of inherent losses. Then the migration of historical default rates and loss severities, internal risk ratings, industry and market conditions and trends, and other environmental factors are considered. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The general allowance is used for estimating the loss on pools of smaller-balance, homogeneous loans; including 1-4 family mortgage loans, installment loans, other consumer loans, and outstanding loan commitments. Also, the general allowance is used for the remaining pool of larger balance, non-homogeneous loans which were not allocated a specific allowance upon their review. The general allowance begins with estimates of

probable losses inherent in the homogeneous portfolio based upon various statistical analyses. These include analysis of historical and peer group delinquency and credit loss experience, together with analyses that reflect current trends and conditions. The Company also considers trends and changes in the volume and term of loans, changes in the credit process and/or lending policies and procedures, and an evaluation of overall credit quality. The general allowance uses a historical loss view as an indicator of future losses. As a result, even though this history is regularly updated with the most recent loss information, it could differ from the loss incurred in the future. The general allowance also captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in the specific allowances.

## EXECUTIVE OVERVIEW

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

Net income of \$1.01 million for the first quarter of 2008 was a 14.0% decrease from the net income for the first quarter of 2007 of \$1.17 million. Loans, net of reserve, totaling \$412.0 million at March 31, 2008, increased 0.7% when compared with December 31, 2007, and increased 0.1% when compared with March 31, 2007. Deposits decreased 3.6% compared with year-end 2007, and decreased 3.3% when compared with March 31, 2007. Assets under WMS management, totaling \$291.2 million at March 31, 2008, declined 1.1% from \$294.5 million at March 31, 2007.

Net interest income is the largest component of net income, and equals the difference between income generated on interest-earning assets and interest expense incurred on interest-bearing liabilities. Future trends regarding net interest income are dependent on the absolute level of market interest rates, the shape of the yield curve, the amount of lost income from non-performing assets, the amount of prepaying loans, the mix and amount of various deposit types, and many other factors, as well as the overall volume of interest-earning assets. These factors are individually difficult to predict, and when taken together, the uncertainty of future trends compounds. Based on management's current projections, net interest income may increase in 2008 and beyond as average interest-earning assets increase, but this may be offset in part or in whole by a possible contraction in the Bank's net interest margin resulting from competitive market conditions and 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 specific nature of the Bank's variability in net interest income due to changes in interest rates, also known as interest rate risk, is to a large degree the result of the Bank's deposit base structure. During 2007, demand deposits, NOW, and savings deposits averaged 17%, 22%, and 8% of total average deposits, respectively, while the more interest-rate sensitive Premium money market accounts, money market accounts, and certificates of deposit averaged 19%, 6% and 28% of total average deposits, respectively.

The Bank continues to have strong credit quality as evidenced by non-performing assets totaling \$2.0 million or 0.49% of total loans at March 31, 2008, as compared with \$2.1 million or 0.51% of total loans at December 31, 2007, and \$1.8 million or 0.42% of total loans at March 31, 2007. The provision for loan losses was \$456,000 for the first quarter of 2008 compared with \$120,000 for the first quarter of 2007. Loan chargeoffs, net of recoveries, totaled \$445,000 or 0.11% of total loans for the first three months of 2008, compared with \$72,000 or 0.02% of total loans for the first three months of 2007. The \$336,000 or 280% increase in the provision for loan losses from first quarter 2007 to first quarter 2008 was largely in response to the increase in net loan chargeoffs, partially offset by the continuation in the relatively low level of remaining non-performing loans over the last year, as well as the small amount of growth in loans outstanding.

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

#### **NET INCOME**

Net income was \$1.01 million for the first quarter of 2008, a 14.0% decrease from the first quarter of 2007 net income of \$1.17 million. Earnings per share on a fully diluted basis were \$0.28 in 2008 compared to \$0.33 in 2007.

Profitability as measured by return on average equity decreased from 12.01% in the first quarter of 2007 to 9.48% for the same period in 2008. Profitability as measured by return on average assets decreased from 0.95% to 0.83% over the same respective quarters in 2007 and 2008. The decline in net income and the corresponding profitability measures was primarily due to the increase in the provision for loan losses of \$336,000 in the first quarter of 2008 compared with the first quarter of 2007.

#### **NET INTEREST INCOME AND EXPENSE**

Net interest income increased \$115,000 or 2.5% to \$4.69 million for the quarter ended March 31, 2008 from \$4.58 million for the quarter ended March 31, 2007. The increase in net interest income was due to the Company's net interest margin increasing from 3.95% in the first quarter of 2007 to 4.15% in the first quarter of 2008, primarily due to the positively sloped yield curve during the first quarter of 2008 compared with the flat and inverted yield curve during the first quarter of 2007. (A positively sloped yield curve is where the interest rate on longer-termed financial instruments exceeds the interest rate on shorter-termed financial instruments, all other factors being equal, while with an inverted yield curve, shorter-termed financial instruments have higher interest rates than longer-termed financial instruments.) The benefit of the positively sloped yield curve was partially offset by competitive pricing pressures. In addition, the impact of the increasing net interest margin was partially offset by the impact of total average earning assets decreasing from \$465.8 million during the first quarter of 2007 to \$453.3 million during the first quarter of 2008. The percentage of average earning assets to total assets decreased to 92.8% for the first quarter of 2008 from 93.4% for the first quarter of 2007.

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

The economic environment changed direction during the fourth quarter of 2007, when the FOMC began lowering the federal funds rate, and the shape of the yield curve became less flat and more positively sloped. Through March 31, 2008, the FOMC has continued the reduction of the federal funds rate. At March 31, 2008, the yield on a three month maturity treasury bond was 1.33% or 118 basis points below the 2.51% yield on a five year treasury and 214 basis points below the 3.47% yield on a 10 year treasury. As a result, the Company's net interest margin improved from 3.95% for the first quarter of 2007 to 4.16% for the fourth quarter of 2007, and 4.15% for the first quarter of 2008. Total interest income decreased \$487,000 or 6.3% to \$7.27 million for the first three months of 2008 from \$7.76 million for the first three months of 2007. This decrease was primarily due to the 29 basis point decrease in the yield on average assets from first quarter 2007 to first quarter 2008, as well as the decrease in total average earning assets of \$12.5 million or 2.7%.

The average yield on loans decreased to 6.61% for the first three months of 2008 compared with 6.96% for the first three months of 2007. Average loan balances decreased 2.5% from \$421.3 million during the first quarter of 2007 to \$410.6 million during the first quarter of 2008. Together, this resulted in a \$480,000 or 6.6% decrease in interest and fee income from loans for the first quarter of 2008 compared with the same period in 2007.

Average investment security balances decreased \$1.9 million from \$39.3 million in the first quarter of 2007 to \$37.4 million in the first quarter of 2008. The tax-equivalent average yield on investments increased from 4.50% for the first quarter of 2007 to 5.02% for the first quarter of 2008. Together, there was an increase in interest and dividend income on security investments of \$3,000 or 0.7%, from \$436,000 for the first three months of 2007 to \$439,000 for the first three months of 2008. Interest income on federal funds sold decreased \$14,000 from the first quarter of 2007 to the first quarter of 2008, reflecting a decline in the average yield from 5.12% to 2.60%.

Total interest expense decreased \$603,000 or 18.9% from \$3.19 million for the first three months of 2007 to \$2.58 million for the first quarter of 2008 primarily due to the overall decline in shorter-term market interest rates. Interest paid on deposits decreased \$344,000 or 14.2% from \$2.42 million for the first quarter of 2007 to \$2.07 million for the first quarter of 2008. Average Premium money market account balances increased \$16.5 million from first quarter 2007 to first quarter 2008, while their average rate decreased from 4.03% to 2.93% over the same period resulting in a decrease of \$33,000 of interest expense for the first quarter of 2008. Average time deposit balances decreased \$23.5 million from first quarter of 2007 to the first quarter of 2008 while the average rate on time deposits decreased from 4.55% to 4.13% resulting in a decrease of \$368,000 in interest expense for the first quarter of 2008. Average NOW deposit balances increased \$15.0 million from the first quarter of 2007 to the first quarter of 2008 while the average rate on NOW accounts increased from 1.15% to 1.27% resulting in an additional \$69,000 of interest expense for the first quarter of 2008.

Interest expense on federal funds purchased decreased \$53,000 for the first three months of 2008 when compared to the first three months of 2007 due to the \$3.2 million decrease in average federal funds purchased and the decline in the average fed funds rate from 5.61% to 4.36%. Interest expense on FHLB of Atlanta advances decreased \$113,000 from the first quarter of 2007 to the first quarter of 2008 due to the decrease in the average rate paid on FHLB advances from 5.08% to 3.88%. The average rate on total interest-bearing liabilities decreased from 3.38% for the first quarter of 2007 to 2.76% for the first quarter of 2008.

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

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

	<b>3 Months Ended March 31, 2008</b>			<b>3 Months Ended March 31, 2007</b>		
	<b>Average Balances</b>	<b>Income/ Expense</b>	<b>Average Rate</b>	<b>Average Balances</b>	<b>Income/ Expense</b>	<b>Average Rate</b>
<b>ASSETS:</b>						
Loans						
Taxable	\$ 401,352	\$ 6,711	6.63%	\$ 411,798	\$ 7,185	6.99%
Tax-exempt (1)	7,347	133	7.17%	7,849	141	7.18%
Nonaccrual (2)	1,877			1,634		
Total Loans	410,576	6,844	6.61%	421,281	7,326	6.96%
Securities						
Taxable	31,927	381	4.77%	38,285	423	4.41%
Tax-exempt (1)	5,447	88	6.48%	1,009	20	7.93%
Total securities	37,374	469	5.02%	39,294	443	4.50%
Deposits in banks	982	8	3.25%	1,888	5	1.01%
Federal funds sold	4,389	29	2.60%	3,329	43	5.12%
Total earning assets	453,321	7,350	6.43%	465,792	7,817	6.72%
Less: Reserve for loan losses	(4,165)			(4,488)		
Cash and due from banks	15,542			14,377		
Bank premises and equipment, net	7,465			7,518		
Other assets	16,436			15,726		
Total Assets	\$ 488,599			\$ 498,925		
<b>LIABILITIES &amp; SHAREHOLDERS EQUITY:</b>						
Deposits						
Demand deposits	\$ 66,716			\$ 74,309		
Interest-bearing deposits						
NOW accounts	85,597	270	1.27%	70,559	201	1.15%
Money market accounts	24,581	89	1.45%	28,646	102	1.45%
Premium money market accounts	74,592	543	2.93%	58,062	576	4.03%

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

Savings accounts	30,442	34	0.45%	34,212	34	0.41%
Time deposits	110,797	1,138	4.13%	134,258	1,506	4.55%
Total interest-bearing deposits	326,009	2,074	2.56%	325,737	2,419	3.01%
Federal funds purchased	3,088	33	4.36%	6,276	87	5.61%
Federal Home Loan Bank advances	42,018	412	3.88%	41,322	525	5.08%
Capital securities of subsidiary trust	4,124	64	6.16%	8,156	156	7.66%
Total interest-bearing liabilities	375,239	2,583	2.76%	381,491	3,187	3.38%
Other liabilities	3,862			3,541		
Shareholders' equity	42,781			39,584		
Total Liabilities & Shareholders' Equity	\$ 488,599			\$ 498,925		
Net interest spread		\$ 4,767	3.67%		\$ 4,630	3.34%
Interest expense as a percent of average earning assets			2.28%			2.77%
Net interest margin			4.15%			3.95%

(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, 2008 Compared to  
Three Months March 31, 2007

	<b>Change</b>	<b>Due to Volume</b>	<b>Due to Rate</b>
<b>INTEREST INCOME</b>			
Loans; taxable	\$ (474)	\$ (293)	(181)
Loans; tax-exempt (1)	(8)	(9)	1
Securities; taxable	(42)	(63)	21
Securities; tax-exempt (1)	68	88	(20)
Deposits in banks	3	(2)	5
Federal funds sold	(14)	14	(28)
 Total Interest Income	 (467)	 (265)	 (202)
 <b>INTEREST EXPENSE</b>			
NOW accounts	69	43	26
Premium NOW accounts	(34)	164	(198)
Money market accounts	(13)	(13)	
Savings accounts		(4)	4
Time deposits	(367)	(263)	(104)
Federal funds purchased and securities sold under agreements to repurchase	(53)	(44)	(9)
Federal Home Loan Bank advances	(113)	9	(122)
Capital securities of subsidiary trust	(92)	(77)	(15)
 Total Interest Expense	 (603)	 (185)	 (418)
 Net Interest Income	 \$ 136	 \$ (80)	 \$ 216

(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 \$456,000 for the first quarter of 2008, compared with \$120,000 for the first quarter of 2007. The amount of the provision for loan loss was based upon management's continual evaluation of the adequacy of the allowance for loan losses, which encompasses the overall risk characteristics of the loan portfolio, trends in the Bank's delinquent and non-performing loans, estimated values of collateral, and the impact of economic conditions on borrowers. Greater weight is given to the loss history by loan category, prolonged changes in portfolio delinquency

trends by loan category, and changes in economic trends. There can be no assurances, however, that future losses will not exceed estimated amounts, or that increased amounts of provisions for loan losses will not be required in future periods.

The increase in the provision for loan losses during the first quarter 2008 was largely in response to the amount of net loan chargeoffs during the same quarter. Loan chargeoffs, net of recoveries, totaled \$445,000 or 0.11% of total loans for the first three months of 2008, compared with \$72,000 or 0.02% of total loans for the first three months of 2007.

#### **NON-INTEREST INCOME**

Total non-interest income increased by \$146,000 from \$1.42 million in the first quarter of 2007 to \$1.57 million in the first quarter of 2008. Non-interest income is derived primarily from non-interest fee income, which consists primarily of fiduciary and other Wealth Management fees, service charges on deposit accounts, and other fee income. This increase stemmed primarily from revenues related to the continued growth of the Bank's deposit base and retail banking activities, as well as an \$88,000 realized gain on the sale of securities.

Wealth Management income increased \$5,000 or 1.3% from first quarter 2007 to first quarter 2008, as assets under management remained relatively stable from year to year. Service charges on deposit accounts increased \$49,000 or 7.4% to \$709,000 for the first three months of 2008, compared with \$660,000 for the same period in 2007 due to the increase in the number of transaction accounts generating fee income. Other service charges, commissions and fees increased \$5,000 or 1.1% from \$424,000 in first quarter 2007 to \$429,000 in first quarter 2008 primarily due to increased income from VISA check card fees. The increase in VISA check fees is primarily due to the increase in the Bank's retail deposit customer base. Included in other service charges, commissions, and income is Bank Owned Life Insurance ( BOLI ) income, which was \$94,000 during the first quarter of 2008 compared with \$87,000 one year earlier. Total BOLI was \$10.1 million at March 31, 2008, compared with \$9.7 million one year earlier.

For the quarter ended March 31, 2008, gross realized gains from sales of three securities available for sale amounted to \$88,000. The proceeds from the sale of these securities, including the realized gain, amounted to \$9.1 million. Two of the securities, totaling approximately \$7.0 million, had a remaining maturity of less than seven months, while the third security, totaling \$2.0 million, had a remaining maturity of 18 months. The proceeds of the sale were redeployed into securities with an average assumed life of approximately five years. There were no securities sold in 2007.

Management does not project any further gains or losses on the sale of securities at this time.

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

#### **NON-INTEREST EXPENSE**

Total non-interest expense increased \$206,000 or 4.9% during the first quarter of 2008 compared with the first quarter of 2007. Salaries and employees' benefits decreased \$20,000, or 0.9%, primarily due to decreases in defined benefit pension plan expenses, partially offset by the customary annual salary increases. Full-time equivalent personnel totaled 144 at March 31, 2008 compared with 148 at March 31, 2007.

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

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

Net occupancy expense increased \$14,000 or 5.3%, and furniture and equipment expense decreased \$1,000 or 0.4%, from first quarter 2007 to first quarter 2008. The increase in occupancy expense primarily reflects increased maintenance and repair expenses, while the decrease in furniture and equipment expenses primarily reflects the decrease in computer software depreciation expense.

Marketing expense increased \$50,000 or 41.0% from \$120,000 for the first quarter of 2007 to \$170,000 for the first quarter of 2008. This increase primarily reflects in implementation of direct mail campaign targeting small businesses. Consulting expense, which includes legal and accounting professional fees, increased \$41,000 or 17.0% in the first quarter of 2008 compared with the first quarter of 2007. This increase primarily reflects the use of information technology consultants assisting the Bank with its technology planning and contract negotiations.

Data processing expense increased \$33,000 or 11.0% for the first three months of 2008 compared with the same time period in 2007. The Bank outsources much of its data processing to a third-party vendor. The increase in expense primarily reflects increased deposit transactions and other data processing system usage by the Bank.

Other operating expenses increased \$90,000 or 14.4% in first quarter 2008 compared with first quarter 2007. This primarily reflects increases in non-loan chargeoffs and contributions to community organizations.

#### **INCOME TAXES**

Income tax expense was \$399,000 for the quarter ended March 31, 2008 compared with \$516,000 for the quarter ended March 31, 2007. The effective tax rates were 28.3% and 30.6% for the first quarter of 2008 and 2007, respectively. The effective tax rate differs from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, and income from the BOLI purchases.

#### **COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2008 AND DECEMBER 31, 2007**

Total assets were \$490.5 million at March 31, 2008 compared with \$489.9 million at December 31, 2007, an increase of 0.1% or \$597,000. Balance sheet categories reflecting significant changes included cash and due from banks, total loans, deposits, federal funds purchased, FHLB advances, and company-obligated mandatorily redeemable capital securities. Each of these categories is discussed below.

**CASH AND DUE FROM BANKS.** Cash and due from banks was \$13.9 million at March 31, 2008, reflecting a decrease of \$2.8 million from December 31, 2007. The decrease in cash and due from banks was primarily due to the decline in cash held at the Fed in order to satisfy reserve requirements.

**LOANS.** Total net loan balance after allowance for loan losses was \$412.0 million at March 31, 2008, which represents an increase of \$2.9 million or 0.7% from \$409.1 million at December 31, 2007. The Bank continually modifies its loan pricing strategies and expands its loan product offerings in an effort to increase lending activity without sacrificing the existing credit quality standards.

**BANK PREMISES AND EQUIPMENT, NET.** Total bank premises and equipment, net, increased \$1.4 million primarily due to purchase of land along Business Route 29 in Warrenton, VA for the purpose of relocating its ViewTree Warrenton branch office.

**DEPOSITS.** For the quarter ended March 31, 2008, total deposits declined by \$14.5 million or 3.6% when compared with total deposits at December 31, 2007. Non-interest-bearing deposits decreased by \$12.8 million and interest-bearing deposits decreased by \$1.7 million. Included in interest-bearing deposits at March 31, 2008 and December 31, 2007 were \$10.2 million and 9.3 million, respectively of brokered deposits. The decline in the Bank's non-interest-bearing deposits and interest-bearing deposits during the first quarter of 2008 was 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 account and other deposits in 2008 and beyond through the expansion of its branch network, as well as by offering value-added NOW and demand deposit products, and selective rate premiums on its interest-bearing deposits.

**FEDERAL FUNDS PURCHASED and FEDERAL HOME LOAN BANK ADVANCES.** Federal funds purchased and FHLB advances increased by \$5 million and \$10 million, respectively, during the quarter ended March 31, 2008, to offset the decline in deposit balances.

**COMPANY-OBLIGATED MANDATORILY REDEEMABLE CAPITAL SECURITIES OF SUBSIDIARY TRUST** ( capital securities ). On March 26, 2002, the Company established a subsidiary trust that issued \$4.0 million of capital securities as part of a pooled trust preferred security offering with other financial institutions. The Company used the offering proceeds for the purposes of expansion and the repurchase of additional shares of its common stock. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve's capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital.

On September 21, 2006, the Company's wholly-owned Connecticut statutory business trust privately issued \$4.0 million face amount of the trust's Floating Rate Capital Securities in a pooled capital securities offering. Simultaneously, the trust used the proceeds of that sale to purchase \$4.0 million principal amount of the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. Both the capital securities and the subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis. The purpose of the September 2006 issuance was to use the proceeds to redeem, on March 26, 2007, the existing capital securities issued on March 26, 2002. Because of changes in the market pricing of capital securities from 2002 to 2006, the September 2006 issuance is priced 190 basis points less than that of the March 2002 issuance, and the repayment of the March 2002 issuance in March 2007 reduced the interest expense associated with the distribution on capital securities of subsidiary trust by \$76,000 annually.

#### **ASSET QUALITY**

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

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

Non-performing assets totaled \$2.0 million or 0.49% of total loans at March 31, 2008, compared with \$2.1 million or 0.51% of total loans at December 31, 2007, and \$1.8 million, or 0.42% of total loans at March 31, 2007.

Total loans past due 90 days or more and still accruing interest totaled \$2.0 million, \$770,000, and \$70,000 on March 31, 2008, December 31, 2007, and March 31, 2007, respectively. The \$2.0 million past due 90 days or more and still accruing at March 31, 2008 consisted of two loans to one borrower collateralized by property under contract for sale scheduled to close during the second quarter of 2008. The proceeds from the sale are adequate to repay all outstanding principal, interest and fees on the two loans. There are no loans, other than those disclosed above as either non-performing or impaired, where information known about the borrower has caused management to have serious doubts about the borrower's ability to repay.

At March 31, 2008, there are no other interest-bearing assets that would be subject to disclosure as either non-performing or impaired.

At March 31, 2008, no concentration of loans to commercial borrowers engaged in similar activities exceeded 10% of total loans. The largest industry concentrations at March 31, 2008 were approximately 6.0% 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 the Company's Annual Report on Form 10-K for the year ended December 31, 2007 entitled "We have a high concentration of loans secured by real estate and a downturn in the real estate market, for any reason, may increase our credit losses, which would negatively affect our financial results."

Based on recently enacted regulatory guidelines, the Bank is now required to monitor the commercial investment real estate loan portfolio for: (a) concentrations above 100% of Tier 1 capital and loan loss reserve for construction and land loans and (b) 300% for permanent investor real estate loans. As of March 31, 2008, construction and land loans are \$39.5 million or 78.18% of the concentration limit, while permanent investor real estate loans (by NAICS code) are \$35.3 million or 69.74% 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 5 of the Notes to Consolidated Financial Statements contained herein.

### CONTRACTUAL OBLIGATIONS

During March 2008, the Bank sold its Route 29 Warrenton branch building and land as part of an exchange of real estate properties. The property the Bank received, also on Route 29 in Warrenton, VA, will be the future site of a larger, more conveniently located branch building. During the time-period of construction of the new branch site, the Bank will rent the existing Route 29 Warrenton branch building for approximately \$180,000 on an annualized basis. As of March 31, 2008, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in Management's Discussion and Analysis in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

### OFF-BALANCE SHEET ARRANGEMENTS

As of March 31, 2008, there have been no material changes to the off-balance sheet arrangements disclosed in Management's Discussion and Analysis in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

### CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and discretionary actions by regulators that could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier I Capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier I Capital to average assets (as defined in the regulations). Management believes, as of March 31, 2008, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

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

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

	Mar. 31, 2008	Dec. 31, 2007
Tier 1 Capital:		
Shareholders' Equity	\$ 42,454	\$ 41,828
Plus: Unrealized loss on securities available for sale/FAS 158 and EITF 06-4	609	773
Less: Intangible assets, net	(105)	(103)
Plus: Company-obligated mandatorily redeemable capital securities	4,000	4,000
Total Tier 1 Capital	46,958	46,498
Tier 2 Capital:		
Allowable Allowance for Loan Losses	4,196	4,185
Total Capital:	51,154	50,683

Risk Weighted Assets:	\$ 387,012	\$ 390,597
-----------------------	------------	------------

Regulatory Capital Ratios:

Leverage Ratio	9.61%	9.49%
Tier 1 to Risk Weighted Assets	12.13%	11.90%
Total Capital to Risk Weighted Assets	13.22%	12.98%

## **CAPITAL RESOURCES AND LIQUIDITY**

Shareholders' equity totaled \$42.5 million at March 31, 2008 compared with \$41.8 million at December 31, 2007 and \$39.6 million (as restated) at March 31, 2007. The amount of equity reflects management's desire to increase shareholders' return on equity while maintaining a strong capital base. The Company initiated an open market stock buyback program in 1998, through which it repurchased 2,680 and 2,435 shares of stock during the first three months of 2008 and 2007, respectively.

Accumulated other comprehensive income/loss decreased to an unrealized loss net of tax benefit of \$610,000 at March 31, 2008 compared with \$773,000 at December 31, 2007. The decline in the accumulated other comprehensive loss was attributable to the decrease in the unrealized loss on investment securities held available for sale.

As discussed above under "Company-obligated Mandatorily Redeemable Capital Securities of Subsidiary Trust", in 2002 and 2006, the Company established subsidiary trusts that issued \$4.0 million and \$4.0 million of capital securities, respectively, as part of two separate pooled trust preferred security offerings with other financial institutions. During 2007, the Company repaid the \$4.0 million issued in 2002. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve's capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital. As discussed above under "Government Supervision and Regulation", banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios. As of March 31, 2008, the appropriate regulatory authorities have categorized the Company and the Bank as "well capitalized."

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

Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled \$14.8 million at March 31, 2008 compared with \$19.6 million at December 31, 2007. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available for sale, of which approximately \$28.7 million was unpledged and readily salable at March 31, 2008.

Furthermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately \$134.5 million at March 31, 2008 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with various commercial banks totaling approximately \$62.0 million. At March 31, 2007, \$45.0 million of the FHLB of Atlanta line of credit and \$5.0 million of federal funds purchased lines of credit were in use.

On April 2, 2008, the FHLB of Atlanta informed the Bank that, in light of continued turmoil in mortgage and credit markets, it would increase the discount applied to residential first mortgage collateral from 20% to 25% effective May 1, 2008. As result of this increase in required collateralization, the Bank's total line of credit with the FHLB of Atlanta will be reduced by approximately \$6.0 million to \$128.5 million on May 1, 2008 from \$134.5 million on March 31, 2008. The Bank does not consider this change in collateral requirements by the FHLB of Atlanta to materially impact the Bank's liquidity.

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



of any current recommendations by regulatory authorities that would have a material effect on liquidity, capital resources or operations.

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

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

	March 31, 2008			December 31, 2007		
	Total	In Use	Available	Total	In Use	Available
Sources:						
Federal funds borrowing						
lines of credit	\$ 62,024	\$ 5,000	\$ 57,024	\$ 52,036	\$	\$ 52,036
Federal Home Loan Bank						
advances	134,577	45,000	89,577	136,159	35,000	101,159
Federal funds sold						2,020
Securities, available for						
sale and unpledged at fair						
value			28,715			23,632
Total short-term funding						
sources			\$ 175,316			\$ 178,847
Uses:						
Unfunded loan						
commitments and lending						
lines of credit			\$ 67,558			\$ 72,503
Letters of credit			6,481			6,749
Total potential short-term						
funding uses			\$ 74,039			\$ 79,252
Ratio of short-term						
funding sources to						
potential short-term						
funding uses			236.8%			225.7%

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

**IMPACT OF INFLATION AND CHANGING PRICES**

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

**CHANGES IN ACCOUNTING PRINCIPLES**

In September 2006, the Emerging Issues Task Force ( EITF ) issued EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. This consensus concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with SFAS 106 (if, in substance, a postretirement benefit plan exists) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007, with early application permitted. The effect that EITF 06-4 had on The Company's consolidated financial statement of condition for March 31, 2008 was a reduction in retained earnings of \$12,000 and an increase in accrued benefit liabilities of \$19,000.

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

#### **FAIR VALUE MEASUREMENTS**

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

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement. Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

##### Securities

Where quoted prices are available in an active market, securities are classified within level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy. At March 31, 2008, all of the Company's securities are considered to be Level 1 or Level 2 securities.

##### Loans held for sale

Loans held for sale which is required to be measured in a lower of cost or fair value. Under SFAS No. 157, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. At March 31, 2008, the Company did not have any loans held for sale.

##### Impaired loans

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

##### Other Real Estate Owned

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

## **RECENT ACCOUNTING PRONOUNCEMENTS**

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

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

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

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

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

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

## **ITEM 4. CONTROLS AND PROCEDURES**

### **Disclosure Controls and Procedures**

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



As of March 31, 2008, management has assessed the effectiveness of the internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the assessment, management determined that it maintained effective internal control over the financial reporting as of March 31, 2008, based on those criteria, and the Company's Chief Executive Officer and Chief Financial Officer can provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America. Smith Elliott Kearns & Company, LLC, the independent registered public accounting firm that audited the Company's consolidated financial statements included in the Company's Annual Report on 10-K for the year ended December 31, 2007, has issued an attestation report on the effectiveness of Management's internal control over reporting as of December 31, 2007. The report, which states an unqualified opinion on the effectiveness of Management's internal control over financial reporting as of December 31, 2007, is incorporated for reference in the Company's Annual Report on 10-K for the year ended December 31, 2007 in Item 8 under the heading Report of Independent Public Accounting Firm.

No changes were made in management's internal control over financial reporting during the quarter ended March 31, 2008 that have materially affected, or that are reasonably likely to materially affect, management's internal control over financial reporting.

## **PART II**

### **ITEM 1. LEGAL PROCEEDINGS**

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

### **ITEM 1A. RISK FACTORS**

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

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

#### **Issuer Purchases of Equity Securities**

	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plan (1)</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plan (1)</b>
January 1 - 31, 2008	1,600	\$ 16.36	1,600	210,641
February 1 - 29, 2008	860	\$ 18.26	860	209,781
March 1 - 31, 2008	220	\$ 18.31	220	209,561
<b>Total</b>	<b>2,680</b>		<b>2,680</b>	

(1) In September 1998, the Company announced an open market buyback program

for its common stock. Annually, the Board resets the amount of shares authorized to be repurchased during the year under the buyback program. On January 17, 2008, the Board authorized the Company to repurchase up to 212,241 shares (6% of the shares of common stock outstanding on January 1, 2008) beginning January 1, 2008 and continuing until the next Board reset.



**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

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

None

**ITEM 5. OTHER INFORMATION**

None

30

---

**ITEM 6. EXHIBITS**

<b>Exhibit Number</b>	<b>Exhibit Description</b>
3.1	Articles of Incorporation of Fauquier Bankshares, Inc., as amended, incorporated by reference to Exhibit 3(i) to registration statement on Form 10 filed April 16, 1999.
3.2	Bylaws of Fauquier Bankshares, Inc., as amended and restated, incorporated by reference to Exhibit 3.2 to Form 8-K filed November 15, 2007.
11	Refer to Part I, Item 1, Note 6 to the Consolidated Financial Statements.
31.1	Certification of CEO pursuant to Rule 13a-14(a).
31.2	Certification of CFO pursuant to Rule 13a-14(a).
32.1	Certification of CEO pursuant to 18 U.S.C. Section 1350.
32.2	Certification of CFO pursuant to 18 U.S.C. Section 1350.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 9, 2008

/s/ Eric P. Graap  
Eric P. Graap  
Executive Vice President & Chief  
Financial Officer  
Dated: May 9, 2008