FAUQUIER BANKSHARES, INC.
Form 10-Q
August 10, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

or

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

For the transition period from _____________to_____________

Commission File No.: 000-25805

Fauquier Bankshares, Inc.
(Exact name of registrant as specified in its charter)

Virginia (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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o

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

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

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

The registrant had 3,695,160 shares of common stock outstanding as of August 3, 2012.

FAUQUIER BANKSHARES, INC.

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Part I. FINANCIAL INFORMATION

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Part I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Balance Sheets

	June 30, 2012 (Unaudited)	December 31, 2011 (Audited)
Assets		
Cash and due from banks	$ 5,150,299	$ 5,544,545
Interest-bearing deposits in other banks	26,081,777	66,607,776
Federal funds sold	11,908	7,904
Securities available for sale	57,588,707	47,649,479
Restricted investments	2,274,500	2,543,200
Loans	459,691,569	458,813,851
Allowance for loan losses	(9,448,983)	(6,728,320)
Net loans	450,242,586	452,085,531
Bank premises and equipment, net	15,323,321	14,788,611
Accrued interest receivable	1,377,324	1,533,758
Other real estate owned, net of allowance	1,776,000	1,776,000
Bank-owned life insurance	11,830,879	11,621,158
Other assets	10,894,240	10,066,086
Total assets	$ 582,551,541	$ 614,224,048
Liabilities		
Deposits:		
Noninterest-bearing	$ 80,527,001	$ 75,310,509
Interest-bearing:		
NOW accounts	170,116,382	184,383,523
Savings accounts and money market accounts	104,459,717	107,004,349
Time deposits	144,996,874	163,871,068
Total interest-bearing	419,572,973	455,258,940
Total deposits	500,099,974	530,569,449
Federal Home Loan Bank advances	25,000,000	25,000,000
Company-obligated mandatorily redeemable capital securities	4,124,000	4,124,000
Other liabilities	5,791,882	6,959,739
Commitments and contingencies	-	-
Total liabilities	535,015,856	566,653,188
Shareholders' Equity		
Common stock, par value, $3.13; authorized 8,000,000 shares; issued and outstanding: 2012: 3,695,160 shares including 31,423 nonvested shares: 2011: 3,669,758 shares including 32,572 nonvested shares	11,467,497	11,384,392
Retained earnings	37,788,947	37,503,865
Accumulated other comprehensive income (loss), net	(1,720,759)	(1,317,397)
Total shareholders' equity	47,535,685	47,570,860

Total liabilities and shareholders' equity	$	582,551,541	$	614,224,048

See accompanying Notes to Consolidated Financial Statements.

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Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)
For the Three Months Ended June 30, 2012 and 2011

	2012	2011
Interest Income		
Interest and fees on loans	$5,983,792	$6,405,669
Interest and dividends on securities available for sale:		
Taxable interest income	276,026	266,645
Interest income exempt from federal income taxes	61,442	60,125
Dividends	18,158	24,010
Interest on federal funds sold	5	5
Interest on deposits in other banks	25,255	31,543
Total interest income	6,364,678	6,787,997
Interest Expense		
Interest on deposits	751,906	968,338
Interest on federal funds purchased	16	-
Interest on Federal Home Loan Bank advances	239,999	246,959
Distribution on capital securities of subsidiary trusts	49,645	49,639
Total interest expense	1,041,566	1,264,936
Net interest income	5,323,112	5,523,061
Provision for loan losses	2,800,000	308,334
Net interest income after provision for loan losses	2,523,112	5,214,727
Other Income		
Trust and estate income	401,015	345,905
Brokerage income	80,504	81,207
Service charges on deposit accounts	653,271	738,974
Other service charges, commissions and income	467,402	409,895
Total other-than-temporary impairment losses on securities	-	-
Less: Portion of gain/(loss) recognized in other comprehensive income before taxes	-	-
Net other-than-temporary impairment losses on securities	-	-
Gain on sale of securities	162,952	3,240
Total other income	1,765,144	1,579,221
Other Expenses		
Salaries and benefits	2,058,222	2,651,374
Occupancy expense of premises	473,651	463,000
Furniture and equipment	309,766	282,794
Marketing expense	154,451	164,370
Legal, audit and consulting expense	274,833	310,190
Data processing expense	306,462	294,381
Federal Deposit Insurance Corporation expense	107,415	194,885
(Gain) loss on sale or impairment and expense of other real estate owned	(6,500)	250,821

Other operating expenses	668,709	651,454
Total other expenses	4,347,009	5,263,269
Income (loss) before income taxes	(58,753)	1,530,679
Income tax expense (benefit)	(137,527)	392,529
Net Income	$78,774	$1,138,150
Earnings per Share, basic	$0.02	$0.31
Earnings per Share, assuming dilution	$0.02	$0.31
Dividends per Share	$0.12	$0.12

See accompanying Notes to Consolidated Financial Statements.

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Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)
For the Six Months Ended June 30, 2012 and 2011

	2012	2011
Interest Income		
Interest and fees on loans	$12,104,457	$12,910,861
Interest and dividends on securities available for sale:		
Taxable interest income	541,994	506,753
Interest income exempt from federal income taxes	122,950	118,009
Dividends	39,791	34,700
Interest on federal funds sold	9	13
Interest on deposits in other banks	62,711	56,546
Total interest income	12,871,912	13,626,882
Interest Expense		
Interest on deposits	1,566,987	1,975,735
Interest on federal funds purchased	31	13
Interest on Federal Home Loan Bank advances	486,812	491,205
Distribution on capital securities of subsidiary trusts	99,578	98,739
Total interest expense	2,153,408	2,565,692
Net interest income	10,718,504	11,061,190
Provision for loan losses	3,300,000	770,835
Net interest income after provision for loan losses	7,418,504	10,290,355
Other Income		
Trust and estate income	742,571	647,773
Brokerage income	162,180	192,897
Service charges on deposit accounts	1,345,196	1,411,429
Other service charges, commissions and income	833,818	759,389
Total other-than-temporary impairment losses on securities	-	(228,306)
Less: Portion of gain/(loss) recognized in other comprehensive income before taxes	-	(39,179)
Net other-than-temporary impairment losses on securities	-	(189,127)
Gain on sale of securities	163,353	4,253
Total other income	3,247,118	2,826,614
Other Expenses		
Salaries and benefits	4,762,574	5,360,950
Occupancy expense of premises	945,208	939,140
Furniture and equipment	585,937	601,230
Marketing expense	319,177	301,886
Legal, audit and consulting expense	532,277	579,871
Data processing expense	618,079	589,740
Federal Deposit Insurance Corporation expense	224,561	392,682
(Gain) loss on sale or impairment and expense of other real estate owned	(8,477)	250,821

Other operating expenses	1,478,364	1,377,681
Total other expenses	9,457,700	10,394,001
Income before income taxes	1,207,922	2,722,968
Income tax expense	175,333	663,932
Net Income	$1,032,589	$2,059,036
Earnings per Share, basic	$0.28	$0.56
Earnings per Share, assuming dilution	$0.28	$0.56
Dividends per Share	$0.24	$0.24

See accompanying Notes to Consolidated Financial Statements.

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

For the Three Months Ended June 30, 2012 and 2011

	2012	2011
Net Income	$78,774	$1,138,150
Other comprehensive income (loss), net of tax:		
Interest rate swap, net of tax effect of $108,373 in 2012 and $40,902 in 2011	(210,370)	(79,398)
Change in fair value of securities available-for-sale net of tax effect of $65,897 in 2012 and $244,114 in 2011	127,918	473,869
Adjustment for gain on sale of securities available for sale, net of tax effect of $55,404 in 2012 and $1,101 in 2011	(107,548)	(2,138)
Adjustment for reclassification for other than temporary impairment net of tax effect	-	-
Total other comprehensive income (loss), net of tax	(190,000)	392,333
Comprehensive Income (Loss)	$(111,226)	$1,530,483

For the Six Months Ended June 30, 2012 and 2011

	2012	2011
Net Income	$ 1,032,589	$ 2,059,036
Other comprehensive income (loss), net of tax:		
Interest rate swap, net of tax effect of $189,491 in 2012 and $22,744 in 2011	(367,836)	(44,151)
Change in fair value of securities available-for-sale net of tax effect of $37,329 in 2012 and $261,408 in 2011	72,287	507,438
Adjustment for gain on sale of securities available for sale, net of tax effect of $55,540 in 2012 and $1,446 in 2011	(107,813)	(2,807)
Adjustment for reclassification for other than temporary impairment net of tax effect of $64,304 in 2011	-	124,824
Total other comprehensive income (loss), net of tax	(403,362)	585,304
Comprehensive Income (Loss)	$ 629,227	$ 2,644,340

See accompanying Notes to Consolidated Financial Statements

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Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
For the Six Months Ended June 30, 2012 and 2011

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2010	$11,277,346	$34,892,905	$ (2,064,688)	$44,105,563
Net income		2,059,036		2,059,036
Other comprehensive income net of tax effect of $301,521			585,304	585,304
Cash dividends ($.24 per share)		(880,742)		(880,742)
Amortization of unearned compensation, restricted stock awards		69,051		69,051
Issuance of common stock - nonvested shares (10,914 shares)	34,161	(34,161)		-
Issuance of common stock - vested shares (4,752 shares)	14,874	53,080		67,954
Exercise of stock options	58,011	91,558		149,569
Balance, June 30, 2011	$11,384,392	$36,250,727	$ (1,479,384)	$46,155,735
Balance, December 31, 2011	$11,384,392	$37,503,865	$ (1,317,397)	$47,570,860
Net income		1,032,589		1,032,589
Other comprehensive income net of tax effect of $207,793			(403,362)	(403,362)
Cash dividends ($.24 per share)		(886,838)		(886,838)
Amortization of unearned compensation, restricted stock awards		69,283		69,283
Issuance of common stock - nonvested shares (13,074 shares)	40,922	(40,922)		-
Issuance of common stock - vested shares (13,477 shares)	42,183	110,970		153,153
Balance, June 30, 2012	$11,467,497	$37,788,947	$ (1,720,759)	$47,535,685

See accompanying Notes to Consolidated Financial Statements

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Fauquier Bankshares, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2012 and 2011
(Unaudited)

	2012	2011
Cash Flows from Operating Activities		
Net income	$1,032,589	$2,059,036
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	577,697	600,017
Disposal of obsolete assets	-	44,708
Provision for loan losses	3,300,000	770,835
Loss on sale or impairment of other real estate	-	250,821
(Gain) on sale and call of securities	(163,353)	(4,253)
Loss on impairment of securities	-	189,127
Amortization of security premiums, net	14,745	51,471
Amortization of unearned compensation, net of forfeiture	69,283	69,051
Changes in assets and liabilities:		
Decrease (increase) in other assets	(852,215)	(130,569)
Increase (decrease) in other liabilities	(1,546,616)	472,099
Net cash provided by(used in) operating activities	2,432,130	4,372,343
Cash Flows from Investing Activities		
Proceeds from sale of securities available for sale	3,684,353	-
Proceeds from maturities, calls and principal payments of securities available for sale	7,187,715	10,005,712
Purchase of securities available for sale	(20,716,518)	(12,384,774)
Purchase of premises and equipment	(1,112,406)	(639,725)
Redemptions (purchases) of restricted securities	268,700	417,700
Net decrease (increase) in loans	(1,457,055)	10,652,639
Proceeds from sale of other real estate owned	-	311,179
Net cash provided by (used in) investing activities	(12,145,211)	8,362,731
Cash Flows from Financing Activities		
Net increase (decrease) in demand deposits, NOW accounts and savings accounts	(11,595,281)	9,631,431
Net (decrease) in certificates of deposit	(18,874,194)	(11,068,912)
Cash dividends paid on common stock	(886,838)	(880,742)
Issuance of common stock	153,153	217,523
Net cash provided by (used in) financing activities	(31,203,160)	(2,100,700)
Increase (decrease) in cash and cash equivalents	(40,916,241)	10,634,374
Cash and Cash Equivalents		
Beginning	72,160,225	47,182,499
Ending	$31,243,984	$57,816,873
Supplemental Disclosures of Cash Flow Information		

Cash payments for:		
Interest	$2,150,531	$2,543,411
Income taxes	$1,067,942	$656,392
Supplemental Disclosures of Noncash Investing Activities		
Unrealized gain (loss) on securities available for sale, net of tax effect	$(35,526)	$629,455
Foreclosed assets acquired in settlement of loans	$-	$1,210,000
Unrealized gain (loss) on interest rate swap, net of taxes	$(367,836)	$(44,151)

See accompanying Notes to Consolidated Financial Statements.

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

Note 1. General

The consolidated financial statements include the accounts of Fauquier Bankshares, Inc. (“the Company”) and its wholly-owned subsidiaries: The Fauquier Bank (“the Bank”) and Fauquier Statutory Trust II; and the Bank's wholly-owned subsidiary, Fauquier Bank Services, Inc. In consolidation, significant intercompany financial balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial positions as of June 30, 2012 and December 31, 2011 and the results of operations for the three and six months ended June 30, 2012 and 2011. The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company’s 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the “SEC”).

The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results expected for the full year.

Recent Accounting Pronouncements

In April 2011, the Financial Accountery Standard Board (the "FASB") issued Accounting Standards Update ("ASU") 2011-03, “Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements.” The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The adaption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, “Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.” This ASU is the result of joint efforts by the FASB and International Accounting Standards Board to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in accounting principals generally accepted in the United States ("U.S. GAAP") (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards . The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The Company has included the required disclosures in its consolidated financial statements.

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In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220) – Presentation of Comprehensive Income." The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. The Company has included the required disclosures in its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company is currently assessing the impact that ASU 2011-11 will have on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, "Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." The amendments are being made to allow FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company
has included the required disclosures in its consolidated financial statements.

In July 2012, the FASB issued ASU 2012-02, "Intangibles-Goodwill and Other (Topic 350) – Testing Indefinite-Lived Intangible Assets for Impairment." The objective of this amendment is to reduce the cost and complexity of performing an impairment test for indefinite-lived intangible assets by simplifying how an entity tests those assets for impairment and to improve consistency in impairment testing guidance among long-lived asset categories. The amendments permit an entity first to assess qualitative factors to determine whether it is more likely than not that an indefinite-lived tangible asset is impaired as a basis for determining whether it is necessary to perform the quantitive impairment test in accordance with Subtopic 350-30, Intangibles-Goodwill and Other-General Intangibles Other than Goodwill. The more-likely-than-not threshold is defined as having likelihood of more than 50 percent. Previous guidance in subtopic 350-30 required an entity to test indefinite-lived intangible assets for impairment, on at least an annual basis, by comparing the fair value of the asset with its carrying amount. If the carrying amount of the intangible asset exceeds its fair value, an entity should recognize an impairment loss in the amount of that excess. In accordance with the amendments in this ASU, an entity will have an option not to calculate annually the fair value of an indefinite-lived intangible asset if the entity determines that it is not more likely than not that asset is impaired. Permiting an entity to assess qualitative factors when testing indefinite-lived intangible assets for impairment results in guidance that is similar to the goodwill impairment testing guidance in ASU 2011-08. The amendments in this ASU are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity's financial statements for the most recent annual or interim period have not yet been issued. The Company is currently assessing the impact that ASU 2012-12 will have on its consolidated financial statements.

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Note 2.Securities

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

	June 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government corporations and agencies	$48,758,210	$ 789,742	$ (10,995)	$ 49,536,957
Obligations of states and political subdivisions	6,788,708	613,580	-	7,402,288
Corporate bonds	3,838,519	-	(3,546,486)	292,033
Mutual funds	341,649	15,780	-	357,429
	$59,727,086	$ 1,419,102	$ (3,557,481)	$ 57,588,707

	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government corporations and agencies	$38,811,926	$ 761,577	$ (1,672)	$ 39,571,831
Obligations of states and political subdivisions	6,791,235	604,331	(1,930)	7,393,636
Corporate bonds	3,793,807	-	(3,458,833)	334,974
Mutual funds	337,060	11,978	-	349,038
	$49,734,028	$ 1,377,886	$ (3,462,435)	$ 47,649,479

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

	June 30, 2012	
	Amortized Cost	Fair Value
Due in one year or less	$ 1,008,926	$ 1,010,359
Due after one year through five years	15,998,534	16,058,087
Due after five years through ten years	11,424,234	12,106,024
Due after ten years	30,953,743	28,056,808
Equity securities	341,649	357,429
	$ 59,727,086	$ 57,588,707

There were no impairment losses on securities during the quarters ended June 30, 2012 and 2011. There were no impairment losses on securities during the six months ended June 30, 2012, and impairment losses on securities of $189,000 occurred during the six months ended June 30, 2011.

During the quarter and six month period ended June 30, 2012, seven securities with a fair value of $3.7 million were sold, resulting in a gain of $162,782. There were no securities sold in the comparable period in 2011. During the quarter ended June 30, 2012, one security with a fair value of $1.0 million was called, resulting in a gain of $170. During the six months ended June 30, 2012, three securities were called totaling a fair value of $3.0 million, resulting in a gain of $571. During the quarter ended June 30, 2011, five securities were called, totaling a fair value of $5.5 million, resulting in a gain of $3,240. During the six months ended June 30, 2011, six securities were called totaling a fair value of $6.5 million, resulting in a gain of $4,253.

The following table shows the Company securities with gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2012 and December 31, 2011, respectively.

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June 30, 2012	Less than 12 Months Fair Value	Unrealized (Losses)	12 Months or More Fair Value	Unrealized (Losses)	Total Fair Value	Unrealized (Losses)
Obligations of U.S. Government, corporations and agencies	$6,704,401	$(10,995)	$-	$-	$ 6,704,401	$ (10,995)
Corporate bonds	-		292,033	(3,546,486)	292,033	(3,546,486)
Total temporary impaired securities	$6,704,401	$(10,995)	$292,033	$(3,546,486)	$ 6,996,434	$ (3,557,481)

December 31, 2011	Less than 12 Months Fair Value	Unrealized (Losses)	12 Months or More Fair Value	Unrealized (Losses)	Total Fair Value	Unrealized (Losses)
Obligations of U.S. Government, corporations and agencies	$1,997,300	$(1,672)	$-	$-	$1,997,300	$(1,672)
Obligations of states and political subdivisions	514,895	(1,930)	-	-	514,895	(1,930)
Corporate bonds	-	-	334,974	(3,458,833)	334,974	(3,458,833)
Total temporary impaired securities	$2,512,195	$(3,602)	$334,974	$(3,458,833)	$2,847,169	$(3,462,435)

The nature of securities which were temporarily impaired for a continuous 12 month period or more at June 30, 2012 consisted of four corporate bonds with a cost basis net of other-than-temporary impairment ("OTTI") totaling $3.8 million and a temporary loss of approximately $3.5 million. The method for valuing these four corporate bonds came from Moody's Analytics. Moody's Analytics employs a two-step discounted cash-flow valuation process. The first step is to evaluate the financial condition of the individual creditors in order to estimate the credit quality of the collateral pool and the structural supports. Step two is to apply a discount rate to the cash flows to calculate a value. These four corporate bonds are the "Class B" or subordinated "mezzanine" tranche of pooled trust preferred securities. The trust preferred securities are collateralized by the interest and principal payments made on trust preferred capital offerings by a geographically diversified pool of approximately 60 different financial institutions per bond. They have an estimated maturity of 25 years. These bonds could have been called at par on the five year anniversary date of issuance, which has already passed for all four bonds. The bonds reprice every three months at a fixed rate index above the three-month London Interbank Offered Rate ("LIBOR"). These bonds have sufficient collateralization and cash flow projections to satisfy their valuation based on the cash flow portion of the OTTI test under authoritative accounting guidance as of June 30, 2012. All four bonds totaling $292,000 at fair value, are greater than 90 days past due, and are classified as nonperforming corporate bond investments in the nonperforming asset table in Note 3.

Additional information regarding each of the pooled trust preferred securities as of June 30, 2012 follows:

Cost, net of OTTI loss	Fair Value	Percent of Underlying Collateral Performing	Percent of Underlying Collateral in Deferral	Percent of Underlying Collateral in Default	Estimated incremental defaults required to break yield (1)	Current Moody's Rating	Cumulative Amount of OTTI Loss	Cumulative Other Comprehensive Loss, net of tax benefit

$	380,763	$	620	56	%	18	%	26	%	broken	C	$ 619,237	$ 250,894
	1,629,133		243,066	68	%	17	%	15	%	broken	Ca	370,867	914,804
	1,280,092		32,606	63	%	29	%	8	%	broken	Ca	719,908	823,341
	548,531		15,741	66	%	23	%	11	%	broken	C	451,469	351,641
$	3,838,519	$	292,033									$ 2,161,481	$ 2,340,680

(1) A break in yield for a given tranche investment means that defaults and/or deferrals have reached such a level that the specific tranche would not receive all of the contractual principal and interest cash flow by its maturity, resulting in not a temporary shortfall, but an actual loss. This column represents the percentage of additional defaults among the currently performing collateral that would result in other-than-temporary loss.

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

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

Beginning balance as of December 31, 2011	$2,206,193
Add: Amount related to the credit loss for which an other-than-temporary impairment was not previously recognized	-
Add: Increases to the amount related to the credit loss for which an other-than temporary impairment was previously recognized	-
Less: Realized losses for securities sold	-
Less: Securities for which the amount previously recognized in other comprehensive income was recognized in earnings because the Company intends to sell the security or more likely than not will be required to to sell the security before recovery of its amortized cost basis.	-
Less: Increases in cash flows expected to be collected that are recognized over the remaining life of the security (See FASB ASC 320-10-35-35)	44,712
Ending balance as of June 30, 2012	$2,161,481

The carrying value of securities pledged to secure deposits and for other purposes amounted to $46 million and $37.3 million at June 30, 2012 and December 31, 2011, respectively.

The Company's restricted investments include an equity investment in the Federal Home Loan Bank of Atlanta ("FHLB"). FHLB stock is generally viewed as a long-term investment and as a restricted investment which is carried at cost because there is no market for the stock other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on ultimate recoverability of the par value rather than recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at June 30, 2012, and no impairment has been recognized.

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Note 3. Loans and Allowance for Loan Losses

Allowance for Loan Losses and Recorded Investment in Loans Receivable

As of December 31, 2011 and for the Six Months Ended June 30, 2012

	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Residential Real Estate	Home Equity Line of Credit	Unallocated
Allowance for Loan Losses							
Beginning balance at 12/31/2011	$794,647	$2,898,784	$195,376	$31,279	$1,584,277	$697,835	$526,122
Charge-offs	(113,357)	(46,185)	-	(81,790)	(126,358)	(227,924)	-
Recoveries	3,248	624	-	10,222	1,751	432	-
Provision	306,683	1,843,875	(77,143)	72,435	753,740	670,292	(269,882)
Ending balance at 6/30/2012	$991,221	$4,697,098	$118,233	$32,146	$2,213,410	$1,140,635	$256,240
Ending balances individually evaluated for impairment	$411,688	$3,233,366	$-	$-	$133,700	$59,600	$-
Ending balances collectively evaluated for impairment	$579,533	$1,463,732	$118,233	$32,146	$2,079,710	$1,081,035	$256,240
Loans Receivable							
Individually evaluated for impairment	$736,203	$16,776,453	$1,800,000	$-	$3,138,577	$386,888	
Collectively evaluated for impairment	26,701,085	188,177,860	34,332,451	5,330,166	136,873,093	45,443,793	
Ending balance at 6/30/2012	$27,437,288	$204,949,313	$36,132,451	$5,330,166	$140,011,670	$45,830,681	

As of and for the year ended December 31, 2011

	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Residential Real Estate	Home Equity Line of Credit	Unallocated	
Allowance for Loan Losses								
Beginning balance at 12/31/2010	$792,796	$2,320,692	$150,513	$314,580	$1,622,830	$1,105,782	$-	$
Charge-offs	(599,320)	-	-	(60,251)	(596,607)	(471,752)	-	
Recoveries	11,750	160,724	-	39,863	-	3,382	-	
Provision	589,421	417,368	44,863	(262,913)	558,054	60,423	526,122	
Ending balance at 12/31/2011	$794,647	$2,898,784	$195,376	$31,279	$1,584,277	$697,835	$526,122	$

Ending balances individually evaluated for impairment	$434,844	$-	$-	$-	$207,700	$37,000	$-	$
Ending balances collectively evaluated for impairment	$359,803	$2,898,784	$195,376	$31,279	$1,376,577	$660,835	$526,122	$
Loans Receivable								
Individually evaluated for impairment	$1,029,765	$4,455,998	$ -	$ -	$3,324,389	$564,996		$
Collectively evaluated for impairment	28,030,939	196,964,154	38,111,739	5,451,186	135,721,738	45,158,947		
Ending balance at 12/31/2011	$29,060,704	$201,420,152	$38,111,739	$5,451,186	$139,046,127	$45,723,943		$

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Credit Quality Indicators

As of June 30, 2012

	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Residential Real Estate	Home Equity Line of Credit	Total
Grade:							
Pass	$21,708,939	$154,122,217	$34,332,451	$5,296,804	$123,955,584	$40,684,459	$380,100,454
Special mention	2,427,990	26,434,648	-	15,705	8,844,863	2,878,367	40,601,573
Substandard	2,877,641	24,392,448	1,800,000	17,657	6,192,032	2,267,855	37,547,633
Doubtful	422,718	-	-	-	1,019,191	-	1,441,909
Loss	-	-	-	-	-	-	-
Total	$27,437,288	$204,949,313	$36,132,451	$5,330,166	$140,011,670	$45,830,681	$459,691,569

As of December 31, 2011

	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Residential Real Estate	Home Equity Line of Credit	Total
Grade:							
Pass	$20,794,642	$149,140,329	$38,111,739	$5,289,040	$128,181,706	$42,532,255	$384,049,711
Special mention	2,901,436	27,414,713	-	82,624	3,422,104	1,067,145	34,888,022
Substandard	4,814,459	24,795,110	-	79,522	6,261,650	2,013,489	37,964,230
Doubtful	550,167	70,000	-	-	1,180,667	111,054	1,911,888
Loss	-	-	-	-	-	-	-
Total	$29,060,704	$201,420,152	$38,111,739	$5,451,186	$139,046,127	$45,723,943	$458,813,851

Age Analysis of Past Due Loans Receivable

As of June 30, 2012

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Financing Receivables	Carrying Amount > 90 Days and Accruing	Nonaccruals
Commercial and industrial	$102,495	$864,560	$101,860	$1,068,915	$26,368,373	$27,437,288	$-	$736,203
Commercial real estate	2,464,196	2,139,304	177,225	4,780,725	200,168,588	204,949,313	-	3,795,346
Construction and land	-	136,119	-	136,119	35,996,332	36,132,451	-	-
Consumer	55,355	18,565	-	73,920	5,256,246	5,330,166	-	-
Residential real estate	1,696,389	962,961	1,788,225	4,447,575	135,564,095	140,011,670	200,693	2,463,450
	649,843	-	504,064	1,153,907	44,676,774	45,830,681	-	386,888

Home equity line of credit								
Total	$4,968,278	$4,121,509	$2,571,374	$11,661,161	$448,030,408	$459,691,569	$200,693	$7,381,887

	As of December 31, 2011							
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Financing Receivables	Carrying Amount > 90 Days and Accruing	Nonaccruals
Commercial and industrial	$216,059	$164,011	$441,960	$822,030	$28,238,674	$29,060,704	$-	$986,927
Commercial real estate	1,655,903	946,185	252,490	2,854,578	198,565,574	201,420,152	-	252,490
Construction and land	371,235	-	-	371,235	37,740,504	38,111,739	-	-
Consumer	139,389	29,398	17,525	186,312	5,264,874	5,451,186	-	3,707
Residential real estate	1,463,022	992,914	1,683,649	4,139,585	134,906,542	139,046,127	101,347	2,928,567
Home equity line of credit	348,105	150,031	53,942	552,078	45,171,865	45,723,943	-	450,248
Total	$4,193,713	$2,282,539	$2,449,566	$8,925,818	$449,888,033	$458,813,851	$101,347	$4,621,939

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Impaired Loans Receivable

	June 30, 2012				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance recorded:					
Commercial and industrial	$ 180,721	$ 180,721	$ -	$ 198,856	$ 1,950
Commercial real estate	6,642,987	6,642,987	-	6,675,190	228,050
Construction and land	1,800,000	1,800,000		1,800,000	18,639
Residential real estate	2,387,269	2,387,269	-	2,415,370	29,300
With an allowance recorded					
Commercial and industrial	555,481	555,481	411,688	560,729	-
Commercial real estate	10,133,466	10,133,466	3,233,366	10,138,921	290,792
Construction and land		-			
Residential real estate	1,138,196	1,138,196	193,300	1,153,449	6,796
Total					
Commercial and industrial	736,202	736,202	411,688	759,585	1,950
Commercial real estate	16,776,453	16,776,453	3,233,366	16,814,111	518,842
Construction and land	1,800,000	1,800,000	-	1,800,000	18,639
Residential real estate	3,525,465	3,525,465	193,300	3,568,819	36,096
Total	$ 22,838,120	$ 22,838,120	$ 3,838,354	$ 22,942,515	$ 575,527

	December 31, 2011				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance recorded:					
Commercial and industrial	$ 345,763	$ 345,763	$ -	$ 363,522	$ 16,884
Commercial real estate	4,455,998	4,455,998	-	4,516,083	377,074

Construction and land	-	-	-	-	-
Residential real estate	2,038,951	2,038,951	-	2,082,239	40,409
With an allowance recorded:					
Commercial and industrial	684,002	684,002	434,844	728,455	19,742
Commercial real estate	-	-	-	-	-
Construction and land	-	-	-	-	-
Residential real estate	1,850,434	1,850,434	244,700	1,907,718	52,879
Total:					
Commercial and industrial	1,029,765	1,029,765	434,844	1,091,977	36,626
Commercial real estate	4,455,998	4,455,998	-	4,516,083	377,074
Construction and land	-	-	-	-	-
Residential real estate	3,889,385	3,889,385	244,700	3,989,957	93,288
Total	$ 9,375,148	$ 9,375,148	$ 679,544	$ 9,598,017	$ 506,988

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

In the third quarter of 2011, the Company adopted the provisions of ASU 2011-02. As a result of adopting the amendments in ASU No. 2011-02, the Company determined that there were four loans totaling $1,604,000 at December 31, 2011 which were classified as Troubled Debt Restructurings ("TDRs"). Upon identifying these receivables as TDRs, the Company identified them as impaired under the guidance in Section 310-10-35. There were five TDRs identified in the quarter ended June 30, 2012 and none in the quarter ended March 31, 2012.

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Troubled Debt Restructurings

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings						
Commercial and industrial	1	$ 237,000	$ 237,000	1	$ 237,000	$ 237,000
Commercial real estate	1	1,900,000	1,900,000	1	1,900,000	1,900,000
Construction and Land	3	1,800,000	1,800,000	3	1,800,000	1,800,000
Consumer	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-
Home equity line of credit	-	-	-	-	-	-
Troubled Debt Restructurings That Subsequently Defaulted						
Commercial and industrial	-	$ -	$ -	-	$ -	$ -
Commercial real estate	-	-	-	-	-	-
Construction and Land	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-
Home equity line of credit	-	-	-	-	-	-

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

(In thousands except as noted)	June 30, 2012		December 31, 2011		June 30, 2011	
Non-accrual loans	$ 7,382		$ 4,621		$ 2,957	
Other real estate owned	1,776		1,776		3,469	
Other repossessed assets owned	-		15		-	
Non-performing corporate bond investments, at fair value	292		335		324	
Total non-performing assets	9,450		6,747		6,750	
Restructured loans still accruing	$ -		-		-	
Loans past due 90 or more days and still accruing	201		101		-	
Total non-performing and other risk assets	$ 9,651		$ 6,848		$ 6,750	
Allowance for loan losses to total loans	2.06	%	1.47	%	1.46	%
Non-accrual loans to total loans	1.61	%	1.01	%	0.65	%
Allowance for loan losses to non-accrual loans	128.00	%	145.61	%	223.73	%
Total non-accrual loans and restructured loans still accruing to total loans	1.61	%	1.01	%	0.65	%
Allowance for loan losses to non-accrual loans and restructured loans still accruing	128.00	%	145.61	%	223.73	%
Total non-performing assets to total assets	1.62	%	1.10	%	1.13	%

Restructured loans on non-accrual status are included with non-accrual loans and not with restructured loans in the above table. There were three loans at June 30, 2012 and four at December 31, 2011, totaling $1,115,043 and $1,603,843, respectively, that were both restructured and on non-accrual status. Restructured loans are included in the specific reserve calculation in the allowance for loan losses and are included in impaired loans.

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

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

Note 4. Company-Obligated Mandatorily Redeemable Capital Securities

On September 21, 2006, the Company’s wholly-owned Connecticut statutory business trust privately issued $4.0 million face amount of the trust’s Floating Rate Capital Securities in a pooled capital securities offering (“Trust II”). Simultaneously, the trust used the proceeds of that sale to purchase $4.0 million principal amount of the Company’s Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. The interest rate on the capital security resets every three months at 1.70% above the then current three month LIBOR. Interest is paid quarterly. Total capital securities at June 30, 2012 and December 31, 2011 were $4,124,000. The Trust II issuance of capital securities and the respective subordinated debentures are callable at any time after five years from the issue date. The subordinated debentures are an unsecured obligation of the Company and are junior in right of payment to all present and future senior indebtedness of the Company. The capital securities are guaranteed by the Company on a subordinated basis.

Note 5. Derivative Instruments and Hedging Activities

U.S. GAAP requires that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the date that the derivative contract is entered into, the Company designates the derivative as a hedge of variable cash flows to be paid or received in conjunction with recognized assets or liabilities, or a cash-flow hedge. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is reported in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income.

The Company formally assesses, both at the hedges’ inception, and on an on-going basis, whether derivatives used in hedging transactions have been highly effective in offsetting changes in cash flows of hedged items and whether those derivatives are expected to remain highly effective in subsequent periods. The Company discontinues hedge accounting when (a) it determines that a derivative is no longer effective in offsetting changes in cash flows of a hedged item; (b) the derivative expires or is sold, terminated or exercised; (c) probability exists that the forecasted transaction will no longer occur; or (d) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all cases in which hedge accounting is discontinued and a derivative remains outstanding, the Company will carry the derivative at fair value in the Consolidated Financial Statements, recognizing changes in fair value in current period income in the consolidated statement of income.

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

The Company uses interest rate swaps to reduce interest rate risks and to manage net interest income. The Company entered into an interest rate swap agreement on July 1, 2010 to manage the interest rate exposure on its Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. By entering into this agreement, the Company converts a floating rate liability into a fixed rate liability through 2020. Under the terms of the agreement, the Company receives interest quarterly at the rate equivalent to three month LIBOR plus 1.70% repricing every three months on the same date as the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036 and pays interest expense monthly at the fixed rate of 4.91%. The interest expense on the interest rate swap was $27,677 and $55,036 for quarter and six months ended June 30, 2012, respectively.

The Company also entered into two swap agreements dated August 15, 2011 to manage the interest rate risk related to two commercial loans. The agreements allow the Company to convert fixed rate assets to floating rate assets through 2021. The Company receives interest monthly at the rate equivalent to one-month LIBOR plus 3.55% repricing on the same date as the loans and pays interest at the fixed rate of 5.875%. The interest expense on the interest rate swaps was $23,154 and $ 45,824 for quarter and six months ended June 30, 2012, respectively.

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

The effects of derivative instruments on the Consolidated Financial Statements for June 30, 2012 and December 31, 2011 are as follows:

(In thousands except as noted) Derivatives designated as hedging instruments	June 30, 2012 Notional/ Contract Amount	Estimated Net Fair Value	Fair Value Balance Sheet Location	Expiration Date
Interest rate swap-10 year cash flow	$ 4,000	$ (544)	Other Liabilities	9/15/2020
Interest rate swap-10 year cash flow	2,097	(140)	Other Liabilities	8/15/2021
Interest rate swap-10 year cash flow	2,225	(147)	Other Liabilities	8/15/2021

	June 30, 2012		
Derivatives in cash flow hedging relationships	Amount of Gain (Loss) Recognized in OCI on Derivatives, net of tax (Effective Portion)	Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion)
Interest rate swap-10 year cash flow	$ (61)	Not applicable	$ -
Interest rate swap-10 year cash flow	(150)	Not applicable	-
Interest rate swap-10 year cash flow	(157)	Not applicable	-
	$ (368)		$ -

Derivatives designated as hedging instruments	December 31, 2011 Notional/ Contract Amount	Estimated Net Fair Value	Fair Value Balance Sheet Location	Expiration Date
Interest rate swap-10 year cash flow	$ 4,000	$ (452)	Other Liabilities	9/15/2020
Interest rate swap-10 year cash flow	2,117	88	Other Assets	8/15/2021
Interest rate swap-10 year cash flow	2,245	91	Other Assets	8/15/2021

	December 31, 2011 Amount of Gain	Location of Gain or (Loss) Recognized in	Amount of Gain (Loss)

Derivatives in cash flow hedging relationships	(Loss) Recognized in OCI on Derivatives, net of tax (Effective Portion)	Income on Derivative (Ineffective Portion)	Recognized in Income on Derivative (Ineffective Portion)
Interest rate swap-10 year cash flow	$(298)	Not applicable	$ -
Interest rate swap-10 year cash flow	58	Not applicable	-
Interest rate swap-10 year cash flow	60	Not applicable	-
	$(180)		$ -

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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.

	Three Months Ended June 30, 2012		Three Months Ended June 30, 2011	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,695,160	$ 0.02	3,699,758	$ 0.31
Effect of dilutive securities, stock-based awards	14,256		16,501	
	3,709,416	$ 0.02	3,716,259	$ 0.31

	Six Months Ended June 30, 2012		Six Months Ended June 30, 2011	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,687,835	$0.28	3,662,596	$ 0.56
Effect of dilutive securities, stock-based awards	12,935		15,338	
	3,700,770	$0.28	3,677,934	$ 0.56

At June 30, 2012, there were no options outstanding.

Note 7. Stock Based Compensation

Stock Incentive Plan

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

Under the Plan, stock options, stock appreciation rights, non-vested and/or restricted shares, and long-term performance unit awards may be granted to directors and certain employees for purchase of the Company’s common stock. The effective date of the Plan is March 19, 2009, the date the Company’s Board approved the Plan, and it has a termination date of December 31, 2019. The Company’s Board may terminate, suspend or modify the Plan within certain restrictions. The Plan authorizes for issuance 350,000 shares of the Company’s common stock. The Plan requires that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant. Such options are generally not exercisable until three years from the date of issuance and generally require continuous employment during the period prior to exercise. The options will expire in no more than ten years after the date of grant. The stock options, stock appreciation rights, restricted shares, and long-term performance unit awards for certain employees are generally subject to vesting requirements and are subject to forfeiture if vesting and other contractual provision requirements are not met. Effective January 1, 2000, the Omnibus Stock Ownership and Long-Term Incentive Plan for employees was amended and restated to include non-employee directors. The Company did not grant stock options during the three months or six months ended June 30, 2012 or June 30, 2011. At June 30, 2012, there were no options outstanding.

Restricted Shares

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

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The Company has granted awards of non-vested shares to certain officers and vested shares (effective March 31, 2010) to non-employee directors under the above-described incentive plans: 11,925 shares, 9,714 shares and 9,784 shares of unvested restricted stock to executive officers and 5,632 shares, 4,752 shares and 5,553 shares of vested restricted stock to non-employee directors on February 16, 2012, February 17, 2011 and March 5, 2010, respectively. Compensation expense for these non-vested shares amounted to $ 34,816 and $ 33,771, net of forfeiture, for the three months ended June 30, 2012 and 2011, respectively. Compensation expense for these non-vested shares amounted to $ 69,283 and $69,050, net of forfeiture, for the six months ended June 30, 2012 and 2011, respectively. The restricted shares issued to non-employee directors are no longer subject to a vesting period. Beginning in 2011, compensation expense for the non-employee director shares is recognized at the date the shares are granted. During the quarter and six months ended June 30, 2012, compensation expense for non-employee director shares was $68,035.

The Company granted performance-based stock rights relating to 11,925, 9,714 and 9,784 shares to certain officers on February 16, 2012, February 17, 2011 and March 5, 2010, respectively, under the Plan.

The performance-based stock rights are accounted for using the fair market value of the Company's common stock on the date the restricted shares were awarded, and adjusted as the market value of the stock changes. The performance-based stock rights shares issued to executive officers are subject to a vesting period, whereby the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded. The award for 2010 is subject to the Company reaching a predetermined return on average equity ratio for the final year of the vesting period as compared to a predetermined peer group of banks. The awards for 2012 and 2011 are subject to the Company reaching a predetermined three year performance average on the return on average equity ratio, also as compared to a predetermined peer group of banks. In the three and six month periods ended June 30, 2012, previously accrued compensation expense of $166,123 for performance-based stock rights was reversed. The compensation expense for performance-based stock rights of $14,953 and $62,870 for the three and six months ended June 30, 2011, respectively.

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

	Six Months Ended June 30, 2012		
	Number of Shares	Weighted Average Exercise Price	Average Intrinsic Value (1)
Outstanding at January 1, 2012	23,732	$ 13.00	
Granted	-		
Exercised	-		
Forfeited	(23,732)	13.00	
Outstanding at June 30, 2012	-	$ -	
Exercisable at end of quarter	-		$ -
Weighted-average fair value per option of options granted during the year			

(1) The aggregate intrinsic value of stock options in the table above reflects the pre-tax intrinsic value (the amount by which the June 30, 2012 market value of the underlying stock option exceeded the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on June 30, 2012. This amount changes based on the changes in the market value of the Company's common stock.

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No options were exercised during the six month period ended June 30, 2012. The total intrinsic value of options exercised during the six months ended June 30, 2011 was $97,303.

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

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	Six Months Ended June 30, 2012		
	Shares		Weighted Average Fair Value
Nonvested at January 1, 2012	32,572	$	12.44
Granted	11,925		12.08
Vested	(13,074)		10.06
Forfeited	-		
Nonvested at June 30, 2012	31,423		13.30

As of June 30, 2012, there was $227,321 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. This type of deferred compensation cost is recognized over a period of three years.

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

	Six Months Ended June 30, 2012		
	Performance Based Stock Rights		Weighted Average Fair Value
Nonvested at January 1, 2012	32,572	$	12.44
Granted	11,925		12.08
Vested	(13,074)		10.06
Forfeited	-		
Nonvested at June 30, 2012	31,423		13.30

Note 8. Employee Benefit Plans

The Company has a defined contribution retirement plan under Internal Revenue Code ("Code") Section 401(k) covering employees who have completed 3 months of service and who are at least 18 years of age. Under the plan, a participant may contribute an amount up to 100% of their covered compensation for the year, not to exceed the dollar limit set by law (Code Section 402(g)). The Company will make an annual matching contribution equal to 100% on the first 1% of compensation deferred and 50% on the next 5% of compensation deferred, for a maximum match of 3.5% of compensation. Beginning in 2010, the Company began making an additional safe harbor contribution equal to 6% of compensation to all eligible participants. The Company's 401(k) expenses for the quarters ended June 30, 2012 and 2011 were $187,500 and $164,000, respectively, and $359,000 and $327,000 for the six months ended June 30, 2012 and 2011, respectively.

The Company also maintains a Director Deferred Compensation Plan ("Deferred Compensation Plan"). This plan provides that any non-employee director of the Company or the Bank may elect to defer receipt of all or any portion of his or her compensation as a director. A participating director may elect to have amounts deferred under the Deferred Compensation Plan held in a deferred cash account, which is credited on a quarterly basis with interest equal to the highest rate offered by the Bank at the end of the preceding quarter. Alternatively, a participant may elect to have a deferred stock account in which deferred amounts are treated as if invested in the Company's common stock at the fair market value on the date of deferral. The value of a stock account will increase and decrease based upon the fair market value of an equivalent number of shares of common stock. In addition, the deferred amounts deemed invested in common stock will be credited with dividends on an equivalent number of shares. Amounts considered invested in the Company's common stock are paid, at the election of the director, either in cash or in whole shares of the common stock and cash in lieu of fractional shares. Directors may elect to receive amounts contributed to their respective accounts in one or up to five installments.

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The Company has a nonqualified deferred compensation plan for a former key employee's retirement, in which the contribution expense is solely funded by the Company. The retirement benefit to be provided is variable based upon the performance of underlying life insurance policy assets. Deferred compensation expense amounted to $8,322 and $474 for the quarters ended June 30, 2012 and 2011, respectively, and $16,644 and $1,185 for the six months ended June 30, 2012 and 2011, respectively..

Concurrent with the establishment of the Deferred Compensation Plan, the Company purchased life insurance policies on this employee with the Company named as owner and beneficiary. These life insurance policies are intended to be utilized as a source of funding the Deferred Compensation Plan. The Company has recorded in other assets of $1,162,847 and $1,145,876 representing cash surrender value of these policies at June 30, 2012 and December 31, 2011, respectively.

Note 9. Fair Value Measurement

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

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

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

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

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

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

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any market activity then the security would fall to the lowest level of the hierarchy (Level 3). The carrying value of restricted Federal Reserve Bank, Community Bankers Bank and FHLB stock approximates fair value based on the redemption provisions of each entity and are therefore excluded from the following table.

Interest rate swaps: Interest rate swaps are recorded at fair value on a recurring basis. The Company utilizes interest rate swap agreements as part of the management of interest rate risk to modify the repricing characteristics of certain portions of the Company's interest-bearing assets and liabilities. The Company determines the fair value of its interest rate swap using externally developed pricing models based on market observable inputs and therefore classifies such valuation as Level 2. The Company has considered counterparty credit risk in the valuation of its interest rate swap assets and has considered its own credit risk in the valuation of its interest rate swap liabilities.

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The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011 by levels within the valuation hierarchy:

		Fair Value Measurements Using		
(In thousands)	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Signicant Unobservable Inputs (Level 3)
Assets at June 30, 2012				
Available-for-sale securities:				
Obligations of U.S. Government corporations and agencies	$ 49,537	$ -	$ 49,537	$ -
Obligations of states and political subdivisions	7,402	-	7,402	-
Corporate bonds	292	-	-	292
Mutual funds	357	357	-	-
Total available-for sale securities	57,588	357	56,939	292
Interest rate swap	-	-	-	-
Total assets at fair value	$ 57,588	$ 357	$ 56,939	$ 292
Liabilities at June 30, 2012				
Interest rate swap	$ 831	$ -	$ 831	$ -
Total liabilities at fair value	$ 831	$ -	$ 831	$ -
Assets at December 31, 2011				
Available-for-sale securities:				
Obligations of U.S. Government corporations and agencies	$ 39,572	$ -	$ 39,572	$ -
Obligations of states and political subdivisions	7,394	-	7,394	-
Corporate bonds	335	-	-	335
Mutual funds	349	349	-	-
Total available-for sale securities	47,650	349	46,966	335
Interest rate swap	179	-	179	-
Total assets at fair value	$ 47,829	$ 349	$ 47,145	$ 335

Liabilities at December 31, 2011				
Interest rate swap	$ 452	$ -	$ 452	$ -
Total liabilities at fair value	$ 452	$ -	$ 452	$ -

Change in Level 3 Fair Value

The changes in Level 3 assets measured at estimated fair value on a recurring basis during the six months ended June 30, 2012 and year ended December 31, 2011 were as follows:

		Total Gains (Losses) Realized/Unrealized			
(In thousands)	Balance January 1, 2012	Included in earnings	Included in Other Comprehensive Income	Transfers in and/or out of Level 3 and 2	Balance June 30, 2012
Available-for-sale securities	$ 335	$ -	$ (43)	$ -	$ 292

		Total Gains (Losses) Realized/Unrealized			
(In thousands)	Balance January 1, 2011	Included in earnings	Included in Other Comprehensive Income	Transfers in and/or out of Level 3 and 2	Balance December 31, 2011
Available-for-sale securities	$ 552	$ (189)	$ (28)	$ -	$ 335

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

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

Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. At June 30, 2012, the Company's Level 3 loans consisted of one relationship totaling $ 692,300 secured by residential real estate with a reserve of $83,000, and three relationships totaling $ 555,500 secured by business assets and inventory with a reserve of $ 411,500.

Other Real Estate Owned ("OREO"): Foreclosed assets are adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair market value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company considers the OREO as nonrecurring Level 2. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers records the OREO as nonrecurring Level 3. Total valuation of OREO property was $1,776,000 at both June 30, 2012 and December 31, 2011.

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

		Carrying Value at June 30, 2012		
(In thousands)	Balance as of June 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Observable Inputs (Level 3)
Assets:				
Impaired loans, net	$ 7,989	$ -	$ 7,236	$ 753
Other real estate owned, net	1,776	-	1,776	-

	Carrying Value at December 31, 2011			
	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Observable Inputs (Level 3)
Assets:				
Impaired loans, net	$ 1,855	$ -	$ 971	$ 884
Other real estate owned, net	1,776	-	1,776	-

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Quantitative Information about Level 3 Fair Value Measurements

(In thousands)	Fair Value Level	Valuation Technique(s)	Unobservable Input	Value*
Securities available-for-sale	3	Discounted cash flow	Constant prepayment rate	1%
			Probability of default	0%-100%
			Loss severity	100%
Impaired Loans	3	Discounted appraised value	Selling cost	4%
			Discount for lack of marketability and age of appraisal	0%-20%
			Probablility of default	> 50%
Other Real Estate Owned	3	Discounted appraised value	Selling cost	8%
			Discount for lack of marketability and age of appraisal	12%

*Range is not shown where there is only a single instance reported.

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

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

Cash and cash equivalents

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

Securities

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

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Loans Receivable

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Life Insurance

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

Interest Rate Swaps

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

Deposit Liabilities

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

Federal Funds Purchased

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

Borrowed Funds

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

Off-Balance-Sheet Financial Instruments

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

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

At June 30, 2012 and December 31, 2011, the fair value of loan commitments and standby letters of credit were deemed immaterial.

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

	Fair Value Measurements at June 30, 2012			
	Balance as of June 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Observable Inputs (Level 3)
Assets				
Cash and short-term investments	$31,278	$ 28,744	$ 2,534	$ -
Securities available for sale	57,588	357	56,939	292
Restricted investments	2,275	-	2,275	-
Net Loans	460,305	-	454,123	753
Accrued interest receivable	1,377	-	1,377	-
Interest rate swap	-	-	-	-
BOLI	11,831	-	11,831	-
Total Financial Assets	$559,225	$ 29,101	$ 529,079	$ 1,045
Liabilities				
Deposits	$502,971	$ -	$ 502,971	$ -
Borrowings	25,856	-	25,856	-
Company obligated mandatorily				
redeemable capital securities	5,249	-	5,249	-
Accrued interest payable	404	-	404	-
Interest rate swaps	831	-	831	-
Total Financial Liabilities	$535,311	$ -	$ 535,311	$ -

	Fair Value Measurements at December 31, 2011			
	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Observable Inputs (Level 3)
Assets				
Cash and short-term investments	$72,207	$69,660	$2,547	$ -
Securities available for sale	47,649	349	46,965	335
Restricted investments	2,543	-	2,543	-
Net Loans	463,449	-	462,565	884
Accrued interest receivable	1,534	-	1,534	-
Interest rate swap	179	-	179	-
BOLI	11,621	-	11,621	-
Total Financial Assets	$599,182	$70,009	$527,954	$ 1,219
Liabilities				
Deposits	$535,567	$-	$535,567	$ -
Borrowings	26,023	-	26,023	-
Company obligated mandatorily				-
redeemable capital securities	4,982	-	4,982	
Accrued interest payable	401	-	401	-

Interest rate swaps	452	-	452	-
Total Financial Liabilities	$567,425	$-	$567,425	$ -

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

Note 10. Subsequent Events

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

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Based on the evaluation, the Company did not identify any recognized or non-recognized subsequent events that would have required adjustment to, or disclosure in, the financial statements.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

GENERAL

The Company was incorporated under the laws of the Commonwealth of Virginia on January 13, 1984. The Company is a registered bank holding company and owns all of the voting shares of The Fauquier Bank ("the Bank"). The Company engages in its business through the Bank, a Virginia state-chartered bank that commenced operations in 1902. The Company has no significant operations other than owning the stock of the Bank. The Company had issued and outstanding 3,695,160 shares of common stock, par value $3.13 per share, held by approximately 406 holders of record on June 30, 2012. The Bank has ten full service branch offices located in the Virginia communities of Old Town-Warrenton, Warrenton, Catlett, The Plains, Sudley Road-Manassas, Old Town-Manassas, New Baltimore, Bealeton, Bristow and Haymarket. An eleventh branch office is currently projected to open in Gainesville, Virginia during 2013. The executive offices of the Company and the main office of the Bank are located at 10 Courthouse Square, Warrenton, Virginia 20186.

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

The Bank provides a range of consumer and commercial banking services to individuals, businesses and industries. The deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"). The basic services offered by the Bank include: interest bearing and non-interest-bearing demand deposit accounts, money market deposit accounts, NOW accounts, time deposits, safe deposit services, 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 Maestro, Accel-Exchange and Plus ATM networks, thereby permitting customers to utilize the convenience of larger ATM networks. The Bank also is a member of the Certificate of Deposit Account Registry Service (“CDARS”) and Insured Cash Sweep Service (“ICS”), to provide customers multi-million dollar FDIC insurance on CD investments and deposit sweeps through the transfer and/or exchange with other FDIC insured institutions. CDARS and ICS are registered service marks of Promontory Interfinancial Network, LLC.

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

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

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

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

As of June 30, 2012, the Company had total consolidated assets of $582.6 million, total loans net of allowance for loan losses of $450.2 million, total consolidated deposits of $500.1 million, and total consolidated shareholders’ equity of $47.5 million.

CRITICAL ACCOUNTING POLICIES

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

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

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

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Specifically, the Company uses both external and internal qualitative factors when determining the non-loan-specific allowances. The external factors utilized include: unemployment in the Company's defined market area of Fauquier County, Prince William County, and the City of Manassas ("market area"), as well as state and national unemployment trends; new residential construction permits for the market area; bankruptcy statistics for the Virginia Eastern District and trends for the United States; and foreclosure statistics for the market area and the state. Quarterly, these external qualitative factors as well as relevant anecdotal information are evaluated from data compiled from local periodicals such as The Washington Post, The Fauquier Times Democrat, and The Bull Run Observer, which cover the Company's market area. Additionally, data is gathered from the Federal Reserve Beige Book for the Richmond Federal Reserve District, Global Insight's monthly economic review, the George Mason School of Public Policy Center for Regional Analysis, and daily economic updates from various other sources. Internal Bank data utilized includes: loans past due aging statistics, nonperforming loan trends, trends in collateral values, loan concentrations, loan review status downgrade trends, and lender turnover and experience trends. Both external and internal data is analyzed on a rolling eight quarter basis to determine risk profiles for each qualitative factor. Ratings are assigned through a defined matrix to calculate the allowance consistent with authoritative accounting literature. A narrative summary of the reserve allowance is produced quarterly and reported directly to the Company's Board of Directors. The Company's application of these qualitative factors to the allowance for loan losses has been consistent over the reporting period.

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

EXECUTIVE OVERVIEW

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

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

Net income of $79,000 for the second quarter of 2012 was a 93.1% decrease from the net income for the second quarter of 2011 of $1.14 million. Net income of $1.03 million for the first six months of 2012 was a 49.9% decrease from the net income for the first six months of 2011 of $2.06 million. Loans, net of reserve, totaling $450.2 million at June 30, 2012, decreased 0.4% when compared with December 31, 2011, but increased 0.5% when compared with June 30, 2011. Deposits, totaling $500.1 million at June 30, 2012, decreased 5.7% compared with year-end 2011, and decreased 3.6% when compared with June 30, 2011. Assets under WMS management, totaling $305.6 million in market value at June 30, 2012, decreased 5.3% from June 30, 2011.

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

The Bank's non-performing assets totaled $9.4 million or 1.62% of total assets at June 30, 2012, as compared with $6.7 million or 1.10% of total assets at December 31, 2011, and $6.7 million or 1.13% of total assets at June 30, 2011. Nonaccrual loans totaled $7.4 million or 1.61% of total loans at June 30, 2012 compared with $4.6 million or 1.01% of total loans at December 31, 2011, and $3.0 million or 0.65% of total loans at June 30, 2011. The provision for loan losses was $3.3 million for the first six months of 2012 compared with $771,000 for the first six months of 2011. The $2.53 million increase in the provision for loan losses was primarily due to the determination of impairment for two commercial real estate loans during the June 2012 quarter. Loan charge-offs, net of recoveries, totaled $579,000 or 0.13% of total average loans for the first six months of 2012, compared with $462,000 or 0.10% of total average loans for the first six months of 2011. Total allowance for loan losses was $9.4 million or 2.06% of total loans at June 30, 2012 compared with $6.7 million or 1.47% of loans at December 31, 2011 and $6.6 million or 1.46% of loans at June 30, 2011.

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COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2012 and JUNE 30, 2011

NET INCOME

Net income of $79,000 for the second quarter of 2012 was a 93.1% decrease from the net income for the second quarter of 2011 of $1.14 million. Earnings per share on a fully diluted basis were $0.02 for the second quarter of 2012 compared with $0.31 for the second quarter of 2011. Profitability as measured by return on average assets decreased from 0.77% in the second quarter of 2011 to 0.05% for the same period in 2012. Profitability as measured by return on average equity decreased from 9.99% to 0.65% over the same respective quarters in 2011 and 2012. The decrease in net income was primarily due to the $2.49 million increase in the provision for loan losses. This was partially offset by a $916,000 reduction in total other expenses in the second quarter of 2012 compared with the second quarter of 2011, as well as a $160,000 increase on the gain from the sale of securities and a $530,000 reduction in income tax expense for the same respective periods .

NET INTEREST INCOME AND EXPENSE

Net interest income decreased $200,000 or 3.6% to $5.32 million for the quarter ended June 30, 2012 from $5.52 million for the quarter ended June 30, 2011. The decrease in net interest income was due primarily to the decline in loan balances and reduced yields on earning assets. This was partially offset by reduced rates on deposits over the same period. The Company’s net interest margin decreased from 4.06% in the second quarter of 2011 to 3.95% in the second quarter of 2012.

Total interest income decreased $423,000 or 6.2% to $6.36 million for the second quarter of 2012 from $6.79 million for the second quarter of 2011. This decrease was primarily due to a 25 basis point decline in the yield on earning assets and reduced loan balances from second quarter 2011 to second quarter 2012. This was partially offset by an increase in balances of investment securities and deposits in other banks.

The tax-equivalent average yield on loans was 5.29% for the second quarter of 2012, down from 5.66% in the second quarter of 2011. Average loan balances decreased $1.8 million or 0.4% from $460.1 million during the second quarter of 2011 to $458.4 million during the second quarter of 2012. The decrease in loans outstanding and yield resulted in a $422,000 or 6.6% decline in interest and fee income from loans for the second quarter of 2012 compared with the same period in 2011.

Average investment security balances increased $8.4 million from $52.3 million in the second quarter of 2011 to $60.7 million in the second quarter of 2012. The tax-equivalent average yield on investments decreased from 2.92% for the second quarter of 2011 to 2.55% for the second quarter of 2012. Interest and dividend income on security investments increased $5,000 or 1.4%, from $351,000 for the second quarter of 2011 to $355,000 for the second quarter of 2012. Interest income on deposits in other banks decreased $6,000 from second quarter 2011 to second quarter 2012 resulting from lower earning balances at the Federal Reserve.

Total interest expense decreased $223,000 or 17.6% from $1.26 million for the second quarter of 2011 to $1.04 million for the second quarter of 2012 primarily due to the decline in interest paid on money market accounts and time deposits.

Interest paid on deposits decreased $216,000 or 22.4% from $968,000 for the second quarter of 2011 to $752,000 for the second quarter of 2012. Average balances on time deposits declined $19.2 million or 11.5% from $166.5 million to $147.3 million while the average rate decreased from 1.67% to 1.57% in the second quarter of 2011 to the second quarter of 2012, resulting in $115,000 less interest expense. Average money market accounts decreased $31.0 million or 42.0% from the second quarter of 2011 to the second quarter of 2012 while the rate declined from 0.48% to 0.21%, resulting in $66,000 less interest expense. Average savings account balances increased $8.8 million from the second quarter of 2011 to the second quarter of 2012, while their average rate decreased from 0.26% to 0.16% over the same period, resulting in a decrease of $11,000 of interest expense for the second quarter of 2012. Average NOW deposit balances increased $22.9 million from the second quarter of 2011 to the second quarter of 2012, while the average rate decreased from 0.43% to 0.31%, resulting in a decrease of $24,000 in NOW interest expense for the second quarter of 2012. The majority of the decrease in money market accounts and the increase in NOW accounts were due to the elimination of the “sweep” money market account and transfer, for the most part, into the business NOW account.

Interest expense on capital securities was virtually unchanged from the second quarter of 2011to the second quarter of 2012.

From the second quarter of 2011 to the second quarter of 2012, interest expense on FHLB of Atlanta advances decreased $7,000. The average rate on total interest-bearing liabilities decreased from 1.08% in the second quarter of 2011 to 0.93% for the second quarter of 2012.

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

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

	Three Months Ended June 30, 2012			Three Months Ended June 30, 2011		
(In thousands except as noted) Assets	Average Balances	Income/ Expense	Average Rate	Average Balances	Income/ Expense	Average Rate
Loans						
Taxable	$444,730	$5,889	5.33 %	$444,085	$6,252	5.65 %
Tax-exempt (1)	8,966	144	6.47 %	13,788	233	6.85 %
Nonaccrual (2)	4,689	-	-	2,275	-	-
Total Loans	458,385	6,033	5.29 %	460,148	6,485	5.66 %
Securities						
Taxable	53,837	294	2.19 %	46,297	291	2.51 %
Tax-exempt (1)	6,890	93	5.40 %	6,024	91	6.05 %
Total securities	60,727	387	2.55 %	52,321	382	2.92 %
Deposits in banks	30,405	25	0.33 %	44,255	32	0.29 %
Federal funds sold	11	-	0.19 %	10	-	0.22 %
Total earning assets	549,528	$6,445	4.72 %	556,734	$6,899	4.97 %
Less: Reserve for loan losses	(7,089)			(6,831)		
Cash and due from banks	4,974			5,471		
Bank premises and equipment, net	15,313			14,257		
Other real estate owned	1,776			3,360		
Other assets	23,466			23,136		
Total Assets	$587,968			$596,127		
Liabilities and Shareholders' Equity						
Deposits						
Demand deposits	$80,552			$76,391		
Interest-bearing deposits						
NOW accounts	167,165	$129	0.31 %	144,306	$153	0.43 %
Money market accounts	42,925	22	0.21 %	73,968	88	0.48 %
Savings accounts	63,648	25	0.16 %	54,864	36	0.26 %
Time deposits	147,281	576	1.57 %	166,506	691	1.67 %
Total interest-bearing deposits	421,019	752	0.72 %	439,644	968	0.88 %
Federal funds purchased	9	-	-	-	-	
Federal Home Loan Bank advances	25,000	240	3.86 %	25,000	247	3.91 %

Capital securities of subsidiary trust	4,124	50	4.84	%	4,124	50	4.83	%
Total interest-bearing liabilities	450,152	1,042	0.93	%	468,768	1,265	1.08	%
Other liabilities	8,739				5,261			
Shareholders' equity	48,525				45,707			
Total Liabilities & Shareholders' Equity	$587,968				$596,126			
Net interest spread		$5,403	3.79	%		$5,634	3.89	%
Interest expense as a percent of average earning assets			0.76	%			0.91	%
Net interest margin			3.95	%			4.06	%

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(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.

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Rate / Volume Variance

	Three Months Ended June 30, 2012 Compared to Three Months Ended June 30, 2011		
(In thousands)	Change	Due to Volume	Due to Rate
Interest Income			
Loans; taxable	$ (363)	$ 9	$ (372)
Loans; tax-exempt (1)	(89)	(81)	(8)
Securities; taxable	3	47	(44)
Securities; tax-exempt (1)	2	13	(11)
Deposits in banks	(7)	(10)	3
Federal funds sold	-	-	-
Total Interest Income	(454)	(22)	(432)
Interest Expense			
NOW accounts	(24)	24	(48)
Money market accounts	(66)	(37)	(29)
Savings accounts	(11)	6	(17)
Time deposits	(115)	(80)	(35)
Federal funds purchased and securities sold under agreements to repurchase	-	-	-
Federal Home Loan Bank advances	(7)	-	(7)
Capital securities of subsidiary trust	-	-	-
Total Interest Expense	(223)	(87)	(136)
Net Interest Income	$ (231)	$ 65	$ (296)

(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

The provision for loan losses was $2.80 million for the second quarter of 2012 compared with $308,000 for the second quarter of 2011. 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 $2.49 million increase in the provision for loan losses is primarily due to the determination by management of impairment for two commercial real estate loans during the June 2012 quarter. The reserve for losses on the two loans was increased from approximately $500,000 during the previous quarter to approximately $2.85 million during the current quarter. The two loans share some of the same borrowers/guarantors. Of the two loans, the first loan has an outstanding balance of $3.2 million, was past due over 60 days at June 30, 2012, and was classified as a nonperforming loan in the nonperforming asset table in Note 3, “Loans and Allowance for Loan Losses” in the financial statements of this Form 10-Q. The second loan has an outstanding balance of $6.9 million, is less than 30 days past due, and has not been classified as nonperforming. Both loans are included as impaired commercial real estate loans in Note 3. The Bank believes that the ultimate collection of interest and principal on these two loans will be derived from both the value of the properties as well as the global cash flow position of the borrower/guarantor group.

OTHER INCOME

Total other income increased by $186,000 from $1.58 million for the second quarter of 2011 to $1.77 million in the second quarter of 2012. Non-interest income is derived primarily from recurring non-interest fee income, which consists primarily of fiduciary trust and other Wealth Management fees, brokerage fees, service charges on deposit accounts, debit card interchange income and other fee income. The increase was primarily due to a $160,000 increase in the gain on the sale of securities during the second quarter of 2012 compared with the second quarter of 2011.

Trust and estate income increased $55,000 or 15.9% from the second quarter of 2011 to the second quarter of 2012 primarily due to an increase in estate settlement revenue.

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Brokerage service revenues decreased $1,000 or 0.9% from the second quarter of 2011 to the second quarter of 2012.

Service charges on deposit accounts decreased $86,000 or 11.6% to $653,000 for the second quarter of 2012 compared to one year earlier. The change is primarily due to changes in the processing of overdrafts, including waiving all charges on low dollar overdrafts, as well as a change in overdraft activities by customers.

Other service charges, commissions and fees increased $57,000 or 14.0% from $410,000 in second quarter of 2011 to $467,000 in the second quarter of 2012. Included in other service charges, commissions, and income is debit card interchange income which totaled $285,000 and $267,000 for the second quarters of 2012 and 2011, respectively. Also included is Bank Owned Life Insurance ("BOLI") income, which was $105,000 during the second quarter of 2012, compared with $104,000 one year earlier. Total BOLI was $11.8 million in cash value at June 30, 2012, compared with $11.4 million one year earlier.

OTHER EXPENSE

Total other expense decreased $916,000 or 17.4% during the second quarter of 2012 compared with the second quarter of 2011, primarily due to the reduction in salary and benefit expenses, FDIC expense, and the loss on the sale or impairment of other real estate owned.

Salaries and employees' benefits decreased $593,000 or 22.4%. The decrease is primarily due to the reversal of $308,000 of previously accrued incentive compensation expense for 2012 compared with $245,000 of accrued incentive compensation during the second quarter of 2011. In addition, active full-time equivalent employees were reduced from 161 as of June 30, 2011 to 151 as of June 30, 2012. For the remainder of 2012, the Company plans no additional net growth in full-time equivalent personnel.

Occupancy expense increased $11,000 or 2.3%, while furniture and equipment expense increased $27,000 or 9.5%, from second quarter 2011 to second quarter 2012. The increase in furniture and equipment expense was due primarily to the purchase of personal computers and software.

Marketing expense decreased from $10,000 or 6.0% for the second quarter of 2011 to $154,000 for the second quarter of 2012. The majority of marketing expense is related to the direct mail program for transaction deposit accounts.

Legal, accounting and consulting expense decreased $35,000 or 11.4% in the second quarter of 2012 compared with the second quarter of 2011 due to reduced outsourced services and management consulting.

Data processing expense increased $12,000 or 4.1% for the second quarter of 2012 compared with the same time period in 2011 due to the growth in customer accounts and transactions processed. The Bank outsources much of its data processing to third-party vendors.

FDIC deposit insurance expense decreased 44.9% from $195,000 for the second quarter of 2011 to $107,000 for the second quarter of 2012. The decline was due to a change in the FDIC assessment base from average deposits to average assets less tangible equity as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. This new lower rate is assumed to be in effect in the near-term, however, future FDIC assessment expense is difficult to project, as it is largely dependent on the relative health of the U.S. banking industry and any resulting changes in regulation.

The gain on sale of other real estate owned ("OREO") was $6,500 for the second quarter of 2012 compared with a loss of $251,000 for the same quarter in 2011.

Other operating expenses increased $17,000 or 2.6% in the second quarter of 2012 compared with the second quarter of 2011. The increase was primarily due to increased telecom and office supplies expense.

INCOME TAXES

Income tax benefit was $138,000 for the quarter ended June 30, 2012 compared with an income tax expense of $393,000 for the quarter ended June 30, 2011. The effective tax benefit rate for the second quarter of 2012 is not a meaningful percentage. The effective tax rate was 25.6% for the second quarter of 2011. The effective tax rate differed from the statutory federal income tax rate of 34% due to the Bank’s investment in tax-exempt loans and securities, income from the BOLI purchases, and community development tax credits.

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COMPARISON OF OPERATING RESULTS FOR THE SIX MONTHS ENDED JUNE 30, 2012 and JUNE 30, 2011

NET INCOME

Net income of $1.03 million for the first six months of 2012 was a 49.9% decrease from the net income for the first six months of 2011 of $2.06 million. Earnings per share on a fully diluted basis were $0.28 for the six months ended June 30, 2012 compared to $0.56 for the six months ended June 30, 2011. Profitability as measured by return on average assets decreased from 0.70% in the six months ended June 30, 2011 to 0.35% for the same period in 2012. Profitability as measured by return on average equity decreased from 9.19% to 4.30% over the same respective six month periods in 2011 and 2012. The decrease in net income was primarily due to the $2.53 million increase in the provision for loan losses. This was partially offset by a $936,000 reduction in total other expenses and a $489,000 reduction in income tax expense into the first half of 2012 compared with the first half of 2011.

NET INTEREST INCOME AND EXPENSE

Net interest income decreased $343,000 or 3.1% to $10.72 million for the six months ended June 30, 2012 from $11.06 million for the six months ended June 30, 2011. The decrease in net interest income was due primarily to the decline in loan balances and reduced yields on earning assets. These were partially offset by reduced rates on deposits and wholesale funding over the same period. The Company’s net interest margin decreased from 4.09% in the six months ended June 30, 2011 to 3.93% in the six months ended June 30, 2012.

Total interest income decreased $755,000 or 5.5% to $12.87 million for the six months ended June 30, 2012 from $13.63 million for the six months ended June 30, 2011. This decrease was primarily due to a 31 basis point decline in the yield on earning assets and reduced average loan balances from the first six months of 2011 to the first six months of 2012. This was partially offset by an increase in balances of investment securities and deposits in other banks.

The average yield on loans was 5.36% for the first six months of 2012, down from 5.71% for the first six months of 2011. Average loan balances decreased $4.2 million or 0.9% from $461.7 million during the six months ended June 30, 2011 to $457.5 million during the six months ended June 30, 2012. The decrease in loans outstanding and yield resulted in an $806,000 or 6.2% decline in interest and fee income from loans for the first six months of 2012 compared with the same period in 2011.

Average investment security balances increased $6.5 million from $51.9 million in the first six months of 2011 to $58.4 million in the first six months of 2012. The tax-equivalent average yield on investments decreased from 2.78% for the first six months of 2011 to 2.63% for the first six months of 2012. Interest and dividend income on security investments increased $45,000 or 6.9%, from $660,000 for the six months ended June 30, 2011 to $705,000 for the six months ended June 30, 2012. Interest income on deposits in other banks increased $6,000 from the first six months of 2011 to the first six months of 2012.

Total interest expense decreased $412,000 or 16.1% from $2.57 million for the six months ended June 30, 2011 to $2.15 million for the six months ended June 30, 2012, primarily due to the decline in interest paid on money market accounts and time deposits.

Interest paid on deposits decreased $409,000 or 20.7% from $1.98 million for the six months ended June 30, 2011 to $1.57 million for the six months ended June 30, 2012. Average balances on time deposits declined $18.0 million or 10.6% from $169.9 million to $151.9 million while the average rate decreased from 1.69% to 1.59% in the first six months of 2011 to the first six months of 2012, resulting in $218,000 less interest expense. Average money market accounts decreased $33.0 million or 42.5% from the first six months of 2011 to the first six months of 2012 while the rate declined from 0.46% to 0.22%, resulting in $130,000 less interest expense. Average savings account balances increased from $8.9 million for the first six months of 2011 to the first six months of 2012, while their average rate decreased from 0.26% to 0.16% over the same period, resulting in a decrease of $21,000 of interest expense for the six months ended June 30, 2012. Average NOW deposit balances increased $32.3 million from the first six months of 2011 to the first six months of 2012, while the average rate decreased from 0.44% to 0.31%, resulting in a decrease of $40,000 in NOW interest expense for the the six months ended June 30, 2012. The decrease in money market accounts and majority of the increase in NOW accounts was due to the elimination of the “sweep” money market account and transfer, for the most part, into the business NOW account.

Interest expense on capital securities increased $1,000 from the first six months of 2011 to the first six months of 2012, while interest expense on FHLB of Atlanta advances decreased $4,000. The average rate on total interest-bearing liabilities decreased from 1.09% during the first six months of 2011 to 0.94% during the first six months of 2012.

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.

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

	Six Months Ended June 30, 2012				Six Months Ended June 30, 2011			
(In thousands except as noted)	Average	Income/	Average		Average	Income/	Average	
Assets	Balances	Expense	Rate		Balances	Expense	Rate	
Loans								
Taxable	$443,617	$11,913	5.40	%	$444,766	$12,581	5.70	%
Tax-exempt (1)	9,032	290	6.47	%	14,814	501	6.82	%
Nonaccrual (2)	4,868	-	-		2,107	-	-	
Total Loans	457,517	12,203	5.36	%	461,687	13,082	5.71	%
Securities								
Taxable	51,464	582	2.26	%	45,916	541	2.36	%
Tax-exempt (1)	6,893	186	5.41	%	5,934	179	6.03	%
Total securities	58,357	768	2.63	%	51,850	720	2.78	%
Deposits in banks	40,880	63	0.31	%	43,003	57	0.27	%
Federal funds sold	9	-	0.20	%	10	-	0.25	%
Total earning assets	556,763	$13,034	4.71	%	556,550	$13,859	5.02	%
Less: Reserve for loan losses	(6,990)				(6,633)			
Cash and due from banks	4,966				5,373			
Bank premises and equipment, net	15,152				14,199			
Other real estate owned	1,776				3,236			
Other assets	23,498				23,310			
Total Assets	$595,165				$596,035			
Liabilities and Shareholders' Equity								
Deposits								
Demand deposits	$78,089				$73,807			
Interest-bearing deposits								
NOW accounts	172,426	$266	0.31	%	140,087	$306	0.44	%
Money market accounts	44,600	48	0.22	%	77,593	178	0.46	%
Savings accounts	64,083	51	0.16	%	55,194	72	0.26	%
Time deposits	151,921	1,202	1.59	%	169,886	1,420	1.69	%
Total interest-bearing deposits	433,030	1,567	0.73	%	442,760	1,976	0.90	%
Federal funds purchased	8	-	0.76	%	4	-	0.68	%
Federal Home Loan Bank advances	25,000	487	3.92	%	25,000	491	3.91	%
Capital securities of subsidiary trust	4,124	100	4.86	%	4,124	99	4.83	%
Total interest-bearing liabilities	462,162	2,154	0.94	%	471,888	2,566	1.09	%
Other liabilities	6,636				5,178			
Shareholders' equity	48,278				45,162			

Total Liabilities & Shareholders' Equity	$595,165				$596,035			
Net interest spread		$10,880	3.77	%		$11,293	3.93	%
Interest expense as a percent of average earning assets			0.78	%			0.93	%
Net interest margin			3.93	%			4.09	%

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(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.

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Rate / Volume Variance

(In thousands)	Six Months Ended June 30, 2012 Compared to Six Months Ended June 30, 2011 Change	 Due to Volume	 Due to Rate
Interest Income			
Loans; taxable	$ (668)	$ (33)	$ (635)
Loans; tax-exempt (1)	(211)	(196)	(15)
Securities; taxable	41	65	(24)
Securities; tax-exempt (1)	7	29	(22)
Deposits in banks	6	(3)	9
Federal funds sold	-	-	-
Total Interest Income	(825)	(138)	(687)
Interest Expense			
NOW accounts	(40)	71	(111)
Money market accounts	(130)	(76)	(54)
Savings accounts	(21)	12	(33)
Time deposits	(218)	(150)	(68)
Federal funds purchased and securities sold under agreements to repurchase	-	-	-
Federal Home Loan Bank advances	(4)	-	(4)
Capital securities of subsidiary trust	1	-	1
Total Interest Expense	(412)	(143)	(269)
Net Interest Income	$ (413)	$ 5	$ (418)

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(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

The provision for loan losses was $3.30 million for the first six months of 2012 compared with $771,000 for the first six months of 2011. The reasons for the increase in the provision for loan losses are the same as discussed for the quarter ended June 30, 2012.

OTHER INCOME

Total other income increased by $421,000 from $2.83 million for the first six months of 2011 to $3.25 million in the first six months of 2012. The increase was primarily due to an $189,000 decrease in other-than-temporary impairment losses on securities during the first six months of 2012 compared with the first six months of 2011. Additionally, there was a $159,000 increase in the gain on the sale of securities during the first six months of 2012 compared with the first six months of 2011, as well as a $95,000 increase in trust and estate income over the same period.

Trust and estate income increased $95,000 or 14.6% from the first six months of 2011 to the first six months of 2012 primarily due to an increase in estate settlement revenue.

Brokerage service revenues decreased $31,000 or 15.9% from the first six months of 2011 to the first six months of 2012 due to better than expected annuity sales in 2011 that did not reoccur in 2012.

Service charges on deposit accounts decreased $66,000 or 4.7% to $1.35 million for the first six months of 2012 compared to one year earlier. The change is primarily due to changes in the processing of overdrafts, including waiving all charges on low dollar overdrafts, as well as a change in overdraft activities by customers.

Other service charges, commissions and fees increased $74,000 or 9.8% from $759,000 in six months ended June 30, 2011 to $834,000 in the six months ended June 30, 2012. Included in other service charges, commissions, and income is debit card interchange income which totaled $529,000 and $486,000 for the first six months of 2012 and 2011, respectively. Also included is BOLI income, which was $210,000 during the first six months of 2012, compared with $207,000 for the same period one year earlier.

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OTHER EXPENSE

Total other expense decreased $936,000 or 9.0% during the six months ended June 30, 2012 compared with the six months ended June 30, 2011, primarily due to the reduction in salary and employee benefits, as well as FDIC expense.

Salaries and employees' benefits decreased $598,000 or 11.2% for the six months ended June 30, 2012 compared with the first six months of 2011. During the first six months of 2011, there was approximately $560,000 of accrued short and long-term incentive compensation that was not accrued in 2012.

Occupancy expense increased $6,000 or 0.6%, while furniture and equipment expense decreased $15,000 or 2.5%, from the six months ended June 30, 2011 to the six months ended June 30, 2012. The decrease in furniture and equipment expense was due primarily to decreases in technology hardware and software depreciation and maintenance.

Marketing expense increased from $302,000 for the first six months of 2011 to $319,000 for the first six months of 2012 due to an increase in direct mail marketing.

Legal, accounting and consulting expense decreased $47,000 or 8.2% in the first six months of 2012 compared with the same period of 2011 primarily due to a re-categorization of certain service maintenance agreements from consulting fees to other operating expense.

FDIC deposit insurance expense decreased 42.8% from $393,000 for the six months ended June 30, 2011 to $225,000 for the six months ended June 30, 2012. The decline was due to a change in the FDIC assessment base from average deposits to average assets less tangible equity as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The gain on sale of OREO was $8,000 for the six months ended June 30, 2012 compared with a loss of $251,000 in 2011.

Data processing expense increased $28,000 or 4.8% for the six months ended June 30, 2012 compared with the same time period in 2011 due to the growth in customer accounts and transactions processed. The Bank outsources much of its data processing to third-party vendors.

Other operating expenses increased $101,000 or 7.3% in the six months ended June 30, 2012 compared with the same period in 2011. The increase was primarily due to the re-categorization of service maintenance agreements from consulting fees to other operating expense. In addition, there were higher fraud and deposit account-related charge-offs in 2012 than in 2011.

INCOME TAXES

Income tax expense was $175,000 for the six months ended June 30, 2012 compared with $664,000 for the six months ended June 30, 2011. The effective tax rates were 14.5% and 24.4% for the first six months of 2012 and 2011, respectively. The effective tax rate differed from the statutory federal income tax rate of 34% due to the Bank's investment in tax-exempt loans and securities, income from the BOLI purchases, and community development tax credits.

COMPARISON OF FINANCIAL CONDITION AT JUNE 30, 2012 and DECEMBER 31, 2011

Total assets were $582.6 million at June 30, 2012 compared with $614.2 million at December 31, 2011, a decrease of 5.2% or $31.7 million. Balance sheet categories reflecting significant changes included interest-bearing deposits in other banks, securities, and deposits. Each of these categories is discussed below.

INTEREST-BEARING DEPOSITS IN OTHER BANKS. Interest-bearing deposits in other banks were $26.1 million at June 30, 2012, reflecting a decrease of $40.5 million from December 31, 2011. The decrease in interest-bearing deposits in other banks was primarily due to the reduction in excess liquidity caused by the increase in investment securities as well as the reduction in the Bank's time deposits.

INVESTMENT SECURITIES. Total investment securities were $57.6 million at June 30, 2012, reflecting an increase of $9.9 million from $47.7 million at December 31, 2011. The increase is due to purchases of government backed mortgage pools that are used to collateralize public deposits in excess of FDIC deposit insurance.

DEPOSITS. For the six months ended June 30, 2012, total deposits decreased by $30.5 million or 5.7% when compared with total deposits at December 31, 2011. Non-interest-bearing deposits increased by $5.2 million and interest-bearing deposits decreased by $35.7 million. Included in interest-bearing deposits at June 30, 2012 and December 31, 2011 were $33.6 million and $42.4 million, respectively, of brokered deposits as defined by the Federal Reserve. Of the $33.6 million in brokered deposits, $29.3 million represent deposits of Bank customers, exchanged through the CDARS' network. With the CDARS' program, funds are placed into certificate of deposits issued by other banks in the network, in increments of less than $250,000, to ensure both principal and interest are eligible for complete FDIC coverage. These deposits are exchanged with other member banks on a dollar-for-dollar basis, bringing the full amount of our customers deposits back to the Bank and making these funds fully available for lending in our community. The increase in the Bank's non-interest-bearing deposits and the decrease in interest-bearing deposits during the first six months of 2012 were the result of many factors difficult to segregate and quantify, and equally difficult to use as factors for future projections. The economy, local competition, retail customer preferences, changes in seasonal cash flows by both commercial and retail customers, changes in business cash management practices by Bank customers, the relative pricing from wholesale funding sources, the in-and-outflow of local government tax receipts, and the Bank's funding needs all contributed to the change in deposit balances. The Bank projects to increase its transaction accounts and other deposits during the remainder of 2012 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.

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ASSET QUALITY

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

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

Non-performing assets totaled $9.4 million or 1.62% of total assets at June 30, 2012, compared with $6.7 million or 1.10% of total assets at December 31, 2011, and $6.7 million or 1.13% of total assets at June 30, 2011. Included in non-performing assets at June 30, 2012 were $292,000 of non-performing pooled trust preferred bonds at market value, $1.8 million of other real estate owned and $7.4 million of non-accrual loans. Non-accrual loans as a percentage of total loans were 1.61% at June 30, 2012, as compared with 1.01% and 0.65% at December 31, 2011 and June 30, 2011, respectfully.

There were two loans totaling $201,000 that were past due 90 days or more and still accruing interest at June 30, 2012, compared with $101,000 on December 31, 2011 and none at June 30, 2011. For additional information regarding non-performing assets and potential loan problems, see “Loans and Allowance for Loan Losses” in Note 3 of the Notes to Consolidated Financial Statements contained herein.

At June 30, 2012, no concentration of loans to commercial borrowers engaged in similar activities exceeded 10% of total loans. The largest industry concentration at June 30, 2012 was approximately 5.3% of loans to the hospitality industry (hotels, motels, inns, etc.).

Based on regulatory guidelines, the Bank is required to monitor the commercial investment real estate loan portfolio for: (a) concentrations above 100% of Tier 1 capital and loan loss reserve for construction and land loans and (b) 300% for permanent investor real estate loans. As of June 30, 2012, construction and land loans were $36.1 million or 63.3% of the concentration limit. Commercial investor real estate loans, including construction and land loans, were $214.0 million or 217.3% of the concentration level.

CONTRACTUAL OBLIGATIONS

As of June 30, 2012, there have been no other material changes outside the ordinary course of business to the contractual obligations disclosed in “Management’s Discussion and Analysis and Results of Operations” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

OFF-BALANCE SHEET ARRANGEMENTS

As of June 30, 2012, there have been no material changes to the off-balance sheet arrangements disclosed in “Management’s Discussion and Analysis and Results of Operations” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and discretionary actions by regulators that could have a direct material effect on the Company’s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier 1 Capital to average assets (as defined in the regulations). Management believes, as of June 30, 2012, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

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At June 30, 2012 and December 31, 2011, the Company exceeded its regulatory capital ratios, as set forth in the following table:

Risk Based Capital Ratios

	June 30, 2012	December 31, 2011
(In thousands except where noted)		
Tier 1 Capital:		
Shareholders' Equity	$ 47,535	$ 47,571
Plus: Unrealized loss on securities available for sale/FAS 158, net	1,411	1,376
Less: Unrealized loss on equity securities, net	-	-
Less: Acumulated net gain (loss) on cash flow hedge and retirement obligations	(309)	(48)
Plus: Company-obligated madatorily redeemable capital securities	4,000	4,000
Less: Disallowed deferred tax assets	-	-
Total Tier 1 Capital	53,255	52,899
Tier 2 Capital:		
Allowable Allowance for Loan Losses	5,557	5,501
Total Capital:	58,812	58,400
Risk Weighted Assets:	$ 440,675	$ 438,830
Regulatory Capital Ratios:		
Leverage Ratio	9.06 %	8.70 %
Tier 1 to Risk Weighted Assets	12.08 %	12.05 %
Total Capital to Risk Weighted Assets	13.35 %	13.31 %

CAPITAL RESOURCES AND LIQUIDITY

Shareholders’ equity totaled $47.5 million at June 30, 2012 compared with $47.6 million at December 31, 2011 and $46.2 million at June 30, 2011. The amount of equity reflects management’s desire to increase shareholders’ return on equity while maintaining a strong capital base. On January 19, 2012, the Company’s Board of Directors authorized the Company to repurchase up to 110,093 shares (3% of common stock outstanding on January 1, 2012) beginning January 1, 2012 and continuing until the next Board reset. No shares were repurchased during the six month period ended June 30, 2012.

Accumulated other comprehensive income/loss increased to an unrealized loss net of tax benefit of $1.7 million at June 30, 2012 compared with $1.3 million at December 31, 2011 and $1.5 million at June 30, 2011.

As discussed in “Company-Obligated Mandatorily Redeemable Capital Securities” in Note 4 of the Notes to Consolidated Financial Statements contained herein, during 2006, the Company established a subsidiary trust that issued $4.0 million of capital securities as part of a separate pooled trust preferred security offering with other financial institutions. Under applicable regulatory guidelines, the capital securities are treated as Tier 1 capital for purposes of the Federal Reserve’s capital guidelines for bank holding companies, as long as the capital securities and all other cumulative preferred securities of the Company together do not exceed 25% of Tier 1 capital. As discussed above under “Capital,” banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios. As of June 30, 2012, the appropriate regulatory authorities have categorized the Company and the Bank as “well capitalized.”

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

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Cash and amounts due from depository institutions, interest-bearing deposits in other banks, and federal funds sold totaled $31.2 million at June 30, 2012 compared with $72.2 million at December 31, 2011. These assets provide a primary source of liquidity for the Bank. In addition, management has designated the entire investment portfolio as available of sale, of which approximately $10.9 million was unpledged and readily salable at June 30, 2012. Furthermore, the Bank has an available line of credit with the FHLB of Atlanta with a borrowing limit of approximately $120.0 million at June 30, 2012 to provide additional sources of liquidity, as well as available federal funds purchased lines of credit with the Federal Reserve and various other commercial banks totaling approximately $71.0 million. At June 30, 2012, $25 million of the FHLB of Atlanta line of credit and no federal funds purchased lines of credit were in use.

The following table sets forth information relating to the Company's sources of liquidity and the outstanding commitments for use of liquidity at June 30, 2012 and December 31, 2011. 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

	June 30, 2012			December 31, 2011		
(In thousands except as noted)	Total	In Use	Available	Total	In Use	Available
Sources:						
Federal funds borrowing lines of credit	$ 71,046	$ -	$ 71,046	$ 58,144	$ -	$ 58,144
Federal Home Loan Bank advances	121,288	25,000	96,288	110,706	25,000	85,706
Federal funds sold and interest-bearing deposits in other banks, excluding requirements			6,535			46,633
Securities, available for sale and unpledged at fair value			10,937			9,671
Total short-term funding sources			$ 184,806			$ 200,154
Uses:						
Unfunded loan commitments and lending lines of credit			$ 71,227			$ 70,737
Letters of credit			4,314			3,992
Total potential short-term funding uses			$ 75,541			$ 74,729
Ratio of short-term funding sources to potential short-term funding uses			244.6 %			267.8 %

IMPACT OF INFLATION AND CHANGING PRICES

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

CHANGES IN ACCOUNTING PRINCIPLES

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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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, 2011.

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.

The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. There have not been any significant changes in the Company's internal control over financial reporting or in other factors that have materially affected or are reasonably likely to materially affect, such controls during the quarter ended June 30, 2012.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

Not applicable to smaller reporting companies.

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

On January 19, 2012, the Company's Board of Directors authorized the Company to repurchase up to 110,093 shares (3% of common stock outstanding on January 1, 2012) beginning January 1, 2012 and continuing until the next Board reset. No shares were repurchased during the six month period ended June 30, 2012.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

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ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description
3.1	Articles of Incorporation of Fauquier Bankshares, Inc., as amended, incorporated by reference to Exhibit 3.1 to Form 10-K filed March 15, 2010.
3.2	By-laws of Fauquier Bankshares, Inc., as amended and restated, incorporated by reference to Exhibit 3.2 to Form 10-Q filed August 9, 2010.
31.1	Certification of CEO pursuant to Rule 13a-14(a).
31.2	Certification of CFO pursuant to Rule 13a-14(a).
32.1	Certification of CEO pursuant to 18 U.S.C. Section 1350.
32.2	Certification of CFO pursuant to 18 U.S.C. Section 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

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

FAUQUIER BANKSHARES, INC.
(Registrant)

/s/ Randy K. Ferrell
Randy K. Ferrell
President & Chief Executive Officer
Dated: August 10, 2012

/s/ Eric P. Graap
Eric P. Graap
Executive Vice President & Chief Financial Officer
Dated: August 10, 2012