

## Section 1: 10-Q (10-Q)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, DC 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2018

Or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No.: 000-25805

**Fauquier Bankshares, Inc.**

(Exact name of registrant as specified in its charter)

**Virginia**

(State or other jurisdiction of  
incorporation or organization)

**54-1288193**

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

**10 Courthouse Square, Warrenton, Virginia**

(Address of principal executive offices)

**20186**

(Zip Code)

**(540) 347-2700**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected to not use extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The registrant had 3,773,836 shares of common stock outstanding as of November 9, 2018.

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FAUQUIER BANKSHARES, INC.

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Part I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Fauquier Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

(In thousands, except share and per share data)	September 30, 2018 (Unaudited)	December 31, 2017
<b>Assets</b>		
Cash and due from banks	\$ 5,383	\$ 5,868
Interest-bearing deposits in other banks	15,587	23,424
Federal funds sold	18	8
Securities available for sale, at fair value	72,629	72,153
Restricted investments	2,495	1,546
Loans	533,016	502,799
Allowance for loan losses	(5,214)	(5,094)
Loans, net	527,802	497,705
Premises and equipment, net	18,302	18,606
Accrued interest receivable	1,944	1,940
Other real estate owned, net	1,356	1,356
Bank-owned life insurance	13,505	13,234
Other assets	10,956	8,773
Total assets	\$ 669,977	\$ 644,613
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing checking	\$ 114,032	\$ 115,682
Interest-bearing:		
Checking	231,830	245,564
Savings and money market accounts	147,897	136,862
Time deposits	72,472	71,915
Total interest-bearing	452,199	454,341
Total deposits	566,231	570,023
Federal funds purchased	5,000	-
Federal Home Loan Bank advances	29,800	7,860
Junior subordinated debt	4,124	4,124
Other liabilities	6,545	6,464
Total liabilities	611,700	588,471
<b>Shareholders' Equity</b>		
Common stock, par value, \$3.13; and additional paid-in capital; authorized 8,000,000 shares; issued and outstanding: 3,773,836 and 3,762,677 shares including 22,569 and 18,062 non-vested shares; respectively	15,707	15,526
Retained earnings	43,683	40,491
Accumulated other comprehensive income (loss), net	(1,113)	125
Total shareholders' equity	58,277	56,142
Total liabilities and shareholders' equity	\$ 669,977	\$ 644,613

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**  
**Consolidated Statements of Income**  
(Unaudited)  
**For the Three and Nine Months Ended September 30, 2018 and 2017**

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
(In thousands, except per share data)				
<b>Interest Income</b>				
Interest and fees on loans	\$ 6,110	\$ 5,455	\$ 17,813	\$ 15,534
Interest and dividends on securities:				
Taxable interest income	388	308	1,093	855
Tax-exempt interest	93	95	282	248
Dividends	50	21	103	72
Interest on deposits in other banks	53	122	313	420
Total interest income	<u>6,694</u>	<u>6,001</u>	<u>19,604</u>	<u>17,129</u>
<b>Interest Expense</b>				
Interest on deposits	635	413	1,631	1,146
Interest on federal funds purchased	16	-	40	-
Interest on Federal Home Loan Bank advances	152	52	371	198
Junior subordinated debt	50	50	149	149
Total interest expense	<u>853</u>	<u>515</u>	<u>2,191</u>	<u>1,493</u>
Net interest income	5,841	5,486	17,413	15,636
<b>Provision for loan losses</b>	195	110	507	395
Net interest income after provision for loan losses	<u>5,646</u>	<u>5,376</u>	<u>16,906</u>	<u>15,241</u>
<b>Noninterest Income</b>				
Trust and estate fees	379	379	1,154	1,151
Brokerage fees	45	38	132	129
Service charges on deposit accounts	413	467	1,261	1,452
Interchange fee income, net	319	302	931	923
Bank-owned life insurance	91	91	271	271
Other service charges, commissions and other income	44	11	168	167
Gain on call of securities available for sale	-	1	838	1
Gain on sale of mortgage loans held for sale, net	33	1	56	1
Total noninterest income	<u>1,324</u>	<u>1,290</u>	<u>4,811</u>	<u>4,095</u>
<b>Noninterest Expenses</b>				
Salaries and benefits	2,999	2,683	8,937	8,271
Occupancy	599	568	1,770	1,750
Furniture and equipment	243	252	760	898
Marketing	190	142	468	378
Legal, audit and consulting	263	263	763	809
Data processing	360	298	961	942
Federal Deposit Insurance Corporation	86	84	279	225
Other operating expenses	744	708	2,601	2,290
Total noninterest expenses	<u>5,484</u>	<u>4,998</u>	<u>16,539</u>	<u>15,563</u>
Income before income taxes	1,486	1,668	5,178	3,773
Income tax expense	169	387	616	734
<b>Net Income</b>	<u>\$ 1,317</u>	<u>\$ 1,281</u>	<u>\$ 4,562</u>	<u>\$ 3,039</u>
<b>Earnings per share, basic</b>	<u>\$ 0.35</u>	<u>\$ 0.34</u>	<u>\$ 1.21</u>	<u>\$ 0.81</u>
<b>Earnings per share, diluted</b>	<u>\$ 0.35</u>	<u>\$ 0.34</u>	<u>\$ 1.21</u>	<u>\$ 0.81</u>
<b>Dividends per share</b>	<u>\$ 0.12</u>	<u>\$ 0.12</u>	<u>\$ 0.36</u>	<u>\$ 0.36</u>

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**  
**Consolidated Statements of Comprehensive Income**  
(Unaudited)  
**For the Three and Nine Months Ended September 30, 2018 and 2017**

(In thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>Net income</b>	\$ 1,317	\$ 1,281	\$ 4,562	\$ 3,039
Other comprehensive income (loss), net of tax:				
Change in fair value of securities available for sale, net of tax, \$101, \$(54), \$219 and \$(476), respectively	(379)	104	(826)	919
Reclassification adjustment for gains included in net income, net of tax, \$-, \$-, \$176 and \$-, respectively	-	-	(662)	-
Interest rate swaps, net of tax, \$(16), \$(2), \$(66) and \$2, respectively	61	4	250	(4)
Total other comprehensive income (loss), net of tax, \$85, \$(56), \$330 and \$(474), respectively	(318)	108	(1,238)	915
<b>Total comprehensive income</b>	<b>\$ 999</b>	<b>\$ 1,389</b>	<b>\$ 3,324</b>	<b>\$ 3,954</b>

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**(Unaudited)**  
**For the Nine Months Ended September 30, 2018 and 2017**

(In thousands, except share and per share data)	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
<b>Balance, December 31, 2016</b>	\$ 15,364	\$ 39,824	\$ (737)	\$ 54,451
Net income	-	3,039	-	3,039
Other comprehensive income, net of tax effect of \$(474)	-	-	915	915
Cash dividends (\$0.36 per share)	-	(1,356)	-	(1,356)
Amortization of unearned compensation, restricted stock awards	53	-	-	53
Issuance of common stock - non-vested shares (3,984 shares)	-	-	-	-
Issuance of common stock - vested shares (5,139 shares)	90	-	-	90
Repurchase of common stock (382 shares)	(7)	-	-	(7)
<b>Balance, September 30, 2017</b>	<u>\$ 15,500</u>	<u>\$ 41,507</u>	<u>\$ 178</u>	<u>\$ 57,185</u>
<b>Balance, December 31, 2017</b>	\$ 15,526	\$ 40,491	\$ 125	\$ 56,142
Net income	-	4,562	-	4,562
Other comprehensive loss, net of tax of \$330	-	-	(1,238)	(1,238)
Cash dividends (\$0.36 per share)	-	(1,360)	-	(1,360)
Amortization of unearned compensation, restricted stock awards	99	-	-	99
Reclassification of net unrealized gains on equity securities from Accumulated Other Comprehensive Income per ASU 2016-01	-	(10)	-	(10)
Issuance of common stock - non-vested shares (7,333 shares)	-	-	-	-
Issuance of common stock - vested shares (4,194 shares)	90	-	-	90
Repurchase of common stock (368 shares)	(8)	-	-	(8)
<b>Balance, September 30, 2018</b>	<u>\$ 15,707</u>	<u>\$ 43,683</u>	<u>\$ (1,113)</u>	<u>\$ 58,277</u>

See accompanying Notes to Consolidated Financial Statements.

**Fauquier Bankshares, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
(Unaudited)  
**For the Nine Months Ended September 30, 2018 and 2017**

(In thousands)	<b>For the Nine Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 4,562	\$ 3,039
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	943	1,018
Provision for loan losses	507	395
Gain on interest rate swaps	(3)	(8)
Gain on calls of securities available for sale	(838)	-
Amortization of security premiums, net	275	118
Amortization of unearned compensation, net of forfeiture	166	90
Issuance of vested restricted stock	90	90
Bank-owned life insurance income	(271)	(271)
Originations of mortgage loans held for sale	(2,042)	(440)
Proceeds from mortgage loans held for sale	2,098	-
Gain on mortgage loans held for sale	(56)	-
Changes in assets and liabilities:		
Increase in other assets	(1,121)	(13)
Increase (decrease) in other liabilities	111	(442)
Net cash provided by operating activities	4,421	3,576
<b>Cash Flows from Investing Activities</b>		
Proceeds from maturities, calls and principal payments of securities available for sale	10,187	10,905
Purchase of securities available for sale	(12,371)	(26,792)
Purchase of premises and equipment	(639)	(407)
(Purchase) redemption of restricted investments, net	(949)	236
Loan originations, net	(30,742)	(27,108)
Net cash used in investing activities	(34,514)	(43,166)
<b>Cash Flows from Financing Activities</b>		
Increase (decrease) in noninterest-bearing checking, interest-bearing checking and savings and money market accounts	(4,348)	6,204
Increase in time deposits	557	3,848
Increase (decrease) in FHLB advances	21,940	(5,056)
Increase in federal funds purchased	5,000	-
Cash dividends paid on common stock	(1,360)	(1,356)
Repurchase of common stock	(8)	(7)
Net cash provided by financing activities	21,781	3,633
Decrease in cash and cash equivalents	(8,312)	(35,957)
<b>Cash and Cash Equivalents</b>		
Beginning	29,300	67,846
Ending	\$ 20,988	\$ 31,889
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 2,075	\$ 1,482
Income taxes	\$ 868	\$ -
<b>Supplemental Disclosures of Noncash Investing Activities</b>		
Unrealized gain (loss) on securities available for sale, net of tax	\$ (826)	\$ 919
Unrealized gain (loss) on interest rate swaps, net of tax	\$ 250	\$ (4)

See accompanying Notes to Consolidated Financial Statements.



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

**Note 1. General**

The consolidated financial statements include the accounts of Fauquier Bankshares, Inc. (the “Company”) and its wholly-owned subsidiary, The Fauquier Bank (the “Bank”), and the Bank’s wholly-owned subsidiaries, Fauquier Bank Services, Inc. and Specialty Properties Acquisitions - VA, LLC. Specialty Properties Acquisitions - VA, LLC was formed with the sole purpose of holding foreclosed property. The consolidated financial statements do not include the accounts of Fauquier Statutory Trust II, a wholly-owned subsidiary of the Company. 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 position as of September 30, 2018 and the results of operations for the three and nine months ended September 30, 2018 and 2017, in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The notes included herein should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company’s 2017 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the “SEC”).

The results of operations for the three and nine months ended September 30, 2018 and 2017 are not necessarily indicative of the results expected for the full year or any other interim period.

Certain amounts in the 2017 consolidated financial statements have been reclassified to conform to the 2018 presentation. No reclassifications were significant and there was no effect on net income.

**Recent Accounting Pronouncements**

In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2016-02, “Leases (Topic 842).” Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company, to date, has not completed its analysis of those leases and is unable to quantify the impact that ASU 2016-02 will have on its consolidated financial statements at this time; however, based on the current nature of its leases, the Company does not expect any significant adjustments.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements. The Company’s management is addressing compliance requirements, data gathering and archiving resources, and analyzing the potential impact of this standard.

In March 2017, the FASB issued ASU No. 2017- 08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310- 20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company is currently assessing the impact that ASU 2017- 08 will have on its consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.” The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods,

including interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted, including adoption in any interim period. The Company is currently assessing the impact that ASU 2017- 12 will have on its consolidated financial statements.

In June 2018, the FASB issued ASU No. 2018-07, “Compensation- Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” The amendments expand the scope of Topic 718 to include share-based payments issued to nonemployees for goods or services, which were previously excluded. The amendments will align the accounting for share-based payments to nonemployees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-07 to have a material impact on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.” The amendments modify the disclosure requirements in Topic 820 to add disclosures regarding changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty. Certain disclosure requirements in Topic 820 are also removed or modified. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Certain of the amendments are to be applied prospectively while others are to be applied retrospectively. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-13 to have a material impact on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-14, “Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans.” These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. Certain disclosure requirements have been deleted while the following disclosure requirements have been added: the weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates and an explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period. The amendments also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed: The projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets and the accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets. The amendments are effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-14 to have a material impact on its consolidated financial statements.

## Note 2. Securities

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." This ASU requires an entity, among other things, to measure equity investments at fair value through net income, with certain exceptions. The Company began measuring its equity investments at fair value through net income and reclassified \$10,000 of Accumulated Other Comprehensive Income (“AOCI”) to retained earnings for the nine months ended September 30, 2018, with no effect on total shareholders' equity.

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

	<b>September 30, 2018</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized (Losses)</b>	<b>Fair Value</b>
(In thousands)				
Obligations of U.S. Government corporations and agencies	\$ 59,228	\$ 17	\$ (1,849)	\$ 57,396
Obligations of states and political subdivisions	14,655	15	(287)	14,383
Corporate bonds	674	176	-	850
	<u>\$ 74,557</u>	<u>\$ 208</u>	<u>\$ (2,136)</u>	<u>\$ 72,629</u>

	<b>December 31, 2017</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized (Losses)</b>	<b>Fair Value</b>
(In thousands)				
Obligations of U.S. Government corporations and agencies	\$ 52,872	\$ 113	\$ (608)	\$ 52,377
Obligations of states and political subdivisions	15,124	191	(60)	15,255
Corporate bonds	3,816	476	(153)	4,139
Mutual funds	386	-	(4)	382
	<u>\$ 72,198</u>	<u>\$ 780</u>	<u>\$ (825)</u>	<u>\$ 72,153</u>

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

	<b>September 30, 2018</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>
(In thousands)		
Due in one year or less	\$ 1,002	\$ 1,000
Due after one year through five years	7,017	6,843
Due after five years through ten years	23,675	22,932
Due after ten years	42,863	41,854
	<u>\$ 74,557</u>	<u>\$ 72,629</u>

During the nine months ended September 30, 2018, no securities were sold, proceeds from calls and principal repayments were \$10.2 million and securities totaling \$12.4 million were purchased. During the nine months ended September 30, 2017, no securities were sold, proceeds from calls and principal repayments were \$10.9 million and securities totaling \$26.8 million were purchased. There were no impairment losses on securities during the nine months ended September 30, 2018 and 2017, respectively.

The following table shows the Company's securities with gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2018 and December 31, 2017, respectively.

	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>
(In thousands)						
<b>September 30, 2018</b>						
Obligations of U.S. Government corporations and agencies	\$ 40,066	\$ (1,047)	\$ 15,829	\$ (802)	\$ 55,895	\$ (1,849)
Obligations of states and political subdivisions	10,613	(237)	1,161	(50)	11,774	(287)
Total temporary impaired securities	<u>\$ 50,679</u>	<u>\$ (1,284)</u>	<u>\$ 16,990</u>	<u>\$ (852)</u>	<u>\$ 67,669</u>	<u>\$ (2,136)</u>

	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>	<b>Fair Value</b>	<b>Unrealized (Losses)</b>
(In thousands)						
<b>December 31, 2017</b>						
Obligations of U.S. Government corporations and agencies	\$ 32,512	\$ (330)	\$ 10,008	\$ (278)	\$ 42,520	\$ (608)
Obligations of states and political subdivisions	4,172	(60)	-	-	4,172	(60)
Corporate bonds	-	-	1,540	(153)	1,540	(153)
Mutual funds	382	(4)	-	-	382	(4)
Total temporary impaired securities	<u>\$ 37,066</u>	<u>\$ (394)</u>	<u>\$ 11,548</u>	<u>\$ (431)</u>	<u>\$ 48,614</u>	<u>\$ (825)</u>

At September 30, 2018, there were approximately 95 securities that were in a loss position due to market conditions, primarily interest rates, and not due to credit concerns.

The nature of securities which were temporarily impaired at September 30, 2018 included one corporate bond with a cost basis net of other-than-temporary impairment ("OTTI") totaling \$674,000. The value of this bond is based on quoted market prices for similar assets and is a "Class B" or subordinated "mezzanine" tranche of pooled trust preferred securities. Trust preferred securities are collateralized by the interest and principal payments made on trust preferred capital offerings by a geographically diversified pool of several different financial institutions. This bond has an estimated maturity of 16 years and could have been called by the Company at par on the five year anniversary date of issuance, which has already passed. The bond reprices every three months at a fixed rate index above the three-month London Interbank Offered Rate ("LIBOR") and has sufficient collateralization and cash flow projections to satisfy its valuation as of September 30, 2018. This bond is projected to repay the full outstanding interest and principal and is classified as performing. During the nine months ended September 30, 2018, two corporate bonds, previously held by the Company, went to auction and were settled at their par value of \$4.0 million, resulting in gains of \$838,000. During the three months ended September 30, 2018 and 2017, \$18,000 and \$55,000 of interest income was recorded, respectively. During the nine months ended September 30, 2018 and 2017, \$97,000 and \$158,000 of interest income was recorded, respectively.

Additional information regarding the pooled trust preferred security as of September 30, 2018 follows:

(Dollars in thousands)

Cost, net of OTTI	Fair Value <sup>(1)</sup>	Percent of Underlying Collateral Performing	Percent of Underlying Collateral in Deferral	Percent of Underlying Collateral in Default	Cumulative Amount of OTTI	Cumulative Other Comprehensive Income, net of tax
\$ 674	\$ 850	88.3%	4.6%	7.1%	\$ 326	\$ (139)

<sup>(1)</sup> Current Moody's Ratings is B2.

The following roll forward reflects the amount related to credit losses recognized in earnings:

(In thousands)

<b>Beginning balance as of December 31, 2017</b>	\$ 1,201
Increases in cash flows expected to be collected that are recognized over the remaining life of the securities	(37)
Reduction for securities called during the period	(838)
<b>Ending balance as of September 30, 2018</b>	<u>\$ 326</u>

The carrying value of securities pledged to secure deposits and for other purposes amounted to \$49.2 million and \$47.6 million at September 30, 2018 and December 31, 2017, respectively.

### Note 3. Loans and Allowance for Loan Losses

The Company segregates its loan portfolio into several loan segments: commercial and industrial, real estate, consumer and student loans. Real estate loans are segregated into the following classes: construction and land, commercial real estate, residential real estate and home equity lines of credit. The following tables present the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment), and total loans and loans by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment).

(In thousands)	September 30, 2018								
	Commercial and Industrial	Commercial Real Estate	Construction and Land	Consumer	Student	Residential Real Estate	Home Equity Lines of Credit	Unallocated	Total
<b>Allowance for Loan Losses</b>									
Beginning balance, December 31, 2017	\$ 518	\$ 1,609	\$ 879	\$ 105	\$ 72	\$ 1,174	\$ 387	\$ 350	\$ 5,094
Charge-offs	(99)	-	(312)	(9)	(21)	-	(80)	-	(521)
Recoveries	31	50	-	4	-	48	1	-	134
Provision	72	158	9	23	23	114	108	-	507
Ending balance, September 30, 2018	<u>\$ 522</u>	<u>\$ 1,817</u>	<u>\$ 576</u>	<u>\$ 123</u>	<u>\$ 74</u>	<u>\$ 1,336</u>	<u>\$ 416</u>	<u>\$ 350</u>	<u>\$ 5,214</u>
Ending balances individually evaluated for impairment	\$ 185	\$ 282	\$ -	\$ -	\$ -	\$ -	\$ 73	\$ -	\$ 540
Ending balances collectively evaluated for impairment	\$ 337	\$ 1,535	\$ 576	\$ 123	\$ 74	\$ 1,336	\$ 343	\$ 350	\$ 4,674
<b>Loans</b>									
Individually evaluated for impairment	\$ 540	\$ 3,583	\$ 2,694	\$ -	\$ -	\$ 713	\$ 573		\$ 8,103
Collectively evaluated for impairment	27,812	180,949	61,584	5,144	9,448	198,436	41,540		524,913
Ending balance, September 30, 2018	<u>\$ 28,352</u>	<u>\$ 184,532</u>	<u>\$ 64,278</u>	<u>\$ 5,144</u>	<u>\$ 9,448</u>	<u>\$ 199,149</u>	<u>\$ 42,113</u>		<u>\$ 533,016</u>

**September 30, 2017**

(In thousands)	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Construction and Land</b>	<b>Consumer</b>	<b>Student</b>	<b>Residential Real Estate</b>	<b>Home Equity Lines of Credit</b>	<b>Unallocated</b>	<b>Total</b>
<b>Allowance for Loan Losses</b>									
Beginning balance, December 31, 2016	\$ 561	\$ 1,569	\$ 661	\$ 21	\$ 76	\$ 943	\$ 307	\$ 387	\$ 4,525
Charge-offs	(15)	(476)	-	(97)	(20)	(51)	-	-	(659)
Recoveries	154	4	-	2	-	4	3	-	167
Provision (recovery)	(270)	400	165	152	11	100	72	(235)	395
Ending balance, September 30, 2017	<u>\$ 430</u>	<u>\$ 1,497</u>	<u>\$ 826</u>	<u>\$ 78</u>	<u>\$ 67</u>	<u>\$ 996</u>	<u>\$ 382</u>	<u>\$ 152</u>	<u>\$ 4,428</u>

**December 31, 2017**

(In thousands)	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Construction and Land</b>	<b>Consumer</b>	<b>Student</b>	<b>Residential Real Estate</b>	<b>Home Equity Lines of Credit</b>	<b>Unallocated</b>	<b>Total</b>
<b>Allowance for Loan Losses</b>									
Beginning balance, December 31, 2016	\$ 561	\$ 1,569	\$ 661	\$ 21	\$ 76	\$ 943	\$ 307	\$ 387	\$ 4,525
Charge-offs	(19)	(476)	-	(114)	(31)	(51)	-	-	(691)
Recoveries	154	575	-	2	-	6	3	-	740
Provision (recovery)	(178)	(59)	218	196	27	276	77	(37)	520
Ending balance, December 31, 2017	<u>\$ 518</u>	<u>\$ 1,609</u>	<u>\$ 879</u>	<u>\$ 105</u>	<u>\$ 72</u>	<u>\$ 1,174</u>	<u>\$ 387</u>	<u>\$ 350</u>	<u>\$ 5,094</u>
Ending balances individually evaluated for impairment	<u>\$ 247</u>	<u>\$ 257</u>	<u>\$ 357</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 51</u>	<u>\$ -</u>	<u>\$ 912</u>
Ending balances collectively evaluated for impairment	<u>\$ 271</u>	<u>\$ 1,352</u>	<u>\$ 522</u>	<u>\$ 105</u>	<u>\$ 72</u>	<u>\$ 1,174</u>	<u>\$ 336</u>	<u>\$ 350</u>	<u>\$ 4,182</u>
<b>Loans</b>									
Individually evaluated for impairment	\$ 758	\$ 3,631	\$ 5,234	\$ -	\$ -	\$ 581	\$ 658		\$ 10,862
Collectively evaluated for impairment	23,655	173,196	48,928	5,068	10,677	186,523	43,890		491,937
Ending balance, December 31, 2017	<u>\$ 24,413</u>	<u>\$ 176,827</u>	<u>\$ 54,162</u>	<u>\$ 5,068</u>	<u>\$ 10,677</u>	<u>\$ 187,104</u>	<u>\$ 44,548</u>		<u>\$ 502,799</u>

The following tables present the recorded investment in loans, by portfolio segment, that have been classified according to the internal risk rating system.

**September 30, 2018**

(In thousands)	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Construction and Land</b>	<b>Consumer</b>	<b>Student</b>	<b>Residential Real Estate</b>	<b>Home Equity Lines of Credit</b>	<b>Total</b>
<b>Grade:</b>								
Pass	\$ 26,431	\$ 175,942	\$ 60,318	\$ 5,141	\$ 9,448	\$ 191,992	\$ 38,816	\$ 508,088
Special mention	964	3,632	2,325	3	-	1,071	425	8,420
Substandard	957	4,958	1,635	-	-	6,086	2,872	16,508
Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
Total	<u>\$ 28,352</u>	<u>\$ 184,532</u>	<u>\$ 64,278</u>	<u>\$ 5,144</u>	<u>\$ 9,448</u>	<u>\$ 199,149</u>	<u>\$ 42,113</u>	<u>\$ 533,016</u>

**December 31, 2017**

(In thousands)	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Construction and Land</b>	<b>Consumer</b>	<b>Student</b>	<b>Residential Real Estate</b>	<b>Home Equity Lines of Credit</b>	<b>Total</b>
Grade:								
Pass	\$ 21,769	\$ 167,625	\$ 44,006	\$ 5,065	\$ 10,677	\$ 180,119	\$ 40,373	\$ 469,634
Special mention	1,152	4,243	143	3	-	763	813	7,117
Substandard	1,492	4,959	10,013	-	-	6,222	3,362	26,048
Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
<b>Total</b>	<b>\$ 24,413</b>	<b>\$ 176,827</b>	<b>\$ 54,162</b>	<b>\$ 5,068</b>	<b>\$ 10,677</b>	<b>\$ 187,104</b>	<b>\$ 44,548</b>	<b>\$ 502,799</b>

The following table presents the aging of the recorded investment in past due loans and nonaccrual loans, by portfolio segment.

**September 30, 2018**

(In thousands)	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater than 90 Days Past Due</b>	<b>Total Past Due</b>	<b>Current</b>	<b>Total Loans</b>	<b>Greater than 90 Days Past Due and Accruing</b>	<b>Nonaccruals</b>
Commercial and industrial	\$ 101	\$ -	\$ 81	\$ 182	\$ 28,170	\$ 28,352	\$ -	\$ 146
Commercial real estate	-	-	1,341	1,341	183,191	184,532	-	1,341
Construction and land	242	-	198	440	63,838	64,278	198	-
Consumer	35	-	-	35	5,109	5,144	2	-
Student	332	477	1,400	2,209	7,239	9,448	1,400	-
Residential real estate	171	-	241	412	198,737	199,149	241	321
Home equity lines of credit	159	140	573	872	41,241	42,113	-	573
<b>Total</b>	<b>\$ 1,040</b>	<b>\$ 617</b>	<b>\$ 3,834</b>	<b>\$ 5,491</b>	<b>\$ 527,525</b>	<b>\$ 533,016</b>	<b>\$ 1,841</b>	<b>\$ 2,381</b>

**December 31, 2017**

(In thousands)	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater than 90 Days Past Due</b>	<b>Total Past Due</b>	<b>Current</b>	<b>Total Loans</b>	<b>Greater than 90 Days Past Due and Accruing</b>	<b>Nonaccruals</b>
Commercial and industrial	\$ 83	\$ 153	\$ 60	\$ 296	\$ 24,117	\$ 24,413	\$ 49	\$ 140
Commercial real estate	-	1,404	-	1,404	175,423	176,827	-	936
Construction and land	430	-	1,335	1,765	52,397	54,162	-	1,335
Consumer	5	22	-	27	5,041	5,068	-	-
Student	504	512	1,616	2,632	8,045	10,677	1,616	-
Residential real estate	637	153	-	790	186,314	187,104	-	181
Home equity lines of credit	337	346	588	1,271	43,277	44,548	-	588
<b>Total</b>	<b>\$ 1,996</b>	<b>\$ 2,590</b>	<b>\$ 3,599</b>	<b>\$ 8,185</b>	<b>\$ 494,614</b>	<b>\$ 502,799</b>	<b>\$ 1,665</b>	<b>\$ 3,180</b>

The following table presents information related to impaired loans, by portfolio segment.

	<b>September 30, 2018</b>				
(In thousands)	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>
<b>With no specific allowance recorded:</b>					
Commercial and industrial	\$ 71	\$ 74	\$ -	\$ 89	\$ 2
Commercial real estate	1,396	1,396	-	1,422	57
Construction and land	2,694	2,693	-	3,296	110
Student	-	-	-	-	-
Residential real estate	713	730	-	723	14
Home equity lines of credit	-	-	-	-	-
Consumer	-	-	-	-	-
<b>With an allowance recorded:</b>					
Commercial and industrial	\$ 469	\$ 501	\$ 185	\$ 591	\$ 16
Commercial real estate	2,187	2,201	282	2,369	30
Construction and land	-	-	-	-	-
Student	-	-	-	-	-
Residential real estate	-	-	-	-	-
Home equity lines of credit	573	600	73	580	-
Consumer	-	-	-	-	-
<b>Total:</b>					
Commercial and industrial	\$ 540	\$ 575	\$ 185	\$ 680	\$ 18
Commercial real estate	3,583	3,597	282	3,791	87
Construction and land	2,694	2,693	-	3,296	110
Student	-	-	-	-	-
Residential real estate	713	730	-	723	14
Home equity lines of credit	573	600	73	580	-
Consumer	-	-	-	-	-
<b>Total</b>	<b>\$ 8,103</b>	<b>\$ 8,195</b>	<b>\$ 540</b>	<b>\$ 9,070</b>	<b>\$ 229</b>

**December 31, 2017**

(In thousands)	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>
<b>With no specific allowance recorded:</b>					
Commercial and industrial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial real estate	2,383	2,383	-	2,429	124
Construction and land	1,829	1,881	-	2,041	56
Student	-	-	-	-	-
Residential real estate	581	585	-	591	22
Home equity lines of credit	70	70	-	70	3
Consumer	-	-	-	-	-
<b>With an allowance recorded:</b>					
Commercial and industrial	\$ 758	\$ 788	\$ 247	\$ 791	\$ 29
Commercial real estate	1,248	1,248	257	1,256	58
Construction and land	3,405	3,433	357	3,451	134
Student	-	-	-	-	-
Residential real estate	-	-	-	-	-
Home equity lines of credit	588	600	51	594	5
Consumer	-	-	-	-	-
<b>Total:</b>					
Commercial and industrial	\$ 758	\$ 788	\$ 247	\$ 791	\$ 29
Commercial real estate	3,631	3,631	257	3,685	182
Construction and land	5,234	5,314	357	5,492	190
Student	-	-	-	-	-
Residential real estate	581	585	-	591	22
Home equity lines of credit	658	670	51	664	8
Consumer	-	-	-	-	-
<b>Total</b>	<b>\$ 10,862</b>	<b>\$ 10,988</b>	<b>\$ 912</b>	<b>\$ 11,223</b>	<b>\$ 431</b>

U.S. GAAP requires that the impairment of loans that have been separately identified for evaluation 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.

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 nonaccrual 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 U.S. GAAP. As is the case for all loans, charge-offs for impaired loans occur when the loan or portion of the loan is determined to be uncollectible.

At September 30, 2018, there were six loans in the portfolio, totaling \$3.5 million, that have been identified as a troubled debt restructures ("TDRs"), of which, five were current and performing in accordance with the modified terms. At December 31, 2017, there were 10 loans in the portfolio, totaling \$5.6 million, that have been identified as TDRs, of which six were current and performing in accordance with the modified terms. There were no loan modifications that were classified as TDRs during the three and nine months ended September 30, 2018 and 2017. There were no defaults on TDRs occurring within 12 months of modification during the three and nine months ended September 30, 2018 and 2017.

At September 30, 2018, the Company had no foreclosed residential real estate property in its possession or in the process of foreclosure.

**Note 4. Junior Subordinated Debt**

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 September 30, 2018 and December 31, 2017 were \$4.1 million. 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 fair value. On the date that the derivative contract is entered into, the Company designates the derivative as a hedge of variable cash flows to be paid or received in conjunction with recognized assets or liabilities, as a cash flow or fair value hedge. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is recorded in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income. For a derivative treated as a fair value hedge, the gain or loss on the derivative, as well as the offsetting gain or loss on the hedged item attributable to the hedged risk, are recognized in interest income. The Company uses interest rate swaps to reduce interest rate risk and to manage net interest income.

The Company formally assesses, both at the hedges' inception, and on an on-going basis, whether derivatives used in hedging transactions have been highly effective in offsetting changes in cash flows of hedged items and whether those derivatives are expected to remain highly effective in subsequent periods. The Company discontinues hedge accounting when (a) it determines that a derivative is no longer effective in offsetting changes in cash flows of a hedged item; (b) the derivative expires or is sold, terminated or exercised; (c) probability exists that the forecasted transaction will no longer occur; or (d) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all cases in which hedge accounting is discontinued and a derivative remains outstanding, the Company will carry the derivative at fair value, recognizing changes in fair value in current period income in the consolidated statements of income. There was no cash flow hedge ineffectiveness identified for the three and nine months ended September 30, 2018 and 2017.

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

The Company entered into an interest rate swap agreement on July 1, 2010 to manage the interest rate exposure on its Floating Rate Junior Subordinated Deferrable Interest Debentures due 2036. By entering into this agreement, the Company converts a floating rate liability into a fixed rate liability through 2020. Under the terms of the agreement, the Company receives interest quarterly at the rate equivalent to three-month LIBOR plus 1.70%, repricing every three months on the same date as the Company's Floating Rate Junior Subordinated Deferrable Interest Debentures, and pays interest expense monthly at the fixed rate of 4.03%. Interest expense on the swap was \$9,000 and \$20,000 for the three months ended September 30, 2018 and 2017, respectively, and \$35,000 and \$63,000 for the nine months ended September 30, 2018 and 2017, respectively. In addition, on June 24, 2016, the Company entered into a forward interest rate swap agreement to convert the floating rate liability on the same Floating Rate Junior Subordinated Deferrable Interest Debentures to fixed from 2020 to 2031. There was no interest expense recognized on the forward interest rate swap for the three and nine months ended September 30, 2018 and 2017, and there will be no exchange of payments until 2020. Both of these swaps are designated as cash flow hedges and changes in the fair value are recorded as an adjustment through other comprehensive income.

The Company entered into two swap agreements 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 2022 and 2025. The Company receives interest monthly at the rate equivalent to one-month LIBOR plus a spread repricing on the same date as the loans and pays interest at fixed rates. Interest income on these swaps was \$3,400 for the three months ended September 30, 2018 and interest expense of \$9,000 for the three months ended September 30, 2017. For nine months ended September 30, 2018 and 2017, interest expense was \$1,000 and \$38,000, respectively. These swaps are designated as fair value hedges and changes in fair value are recorded in current earnings.

Cash collateral held at other banks for these swaps was \$430,000 and \$1.2 million at September 30, 2018 and December 31, 2017, respectively. Collateral posted and received is dependent on the market valuation of the underlying hedges.

The effects of derivative instruments on the consolidated financial statements as of September 30, 2018 and December 31, 2017 are as follows:

(In thousands)

Derivatives designated as hedging instruments	September 30, 2018				
	Notional/Contract	Fair Value		Fair Value	Expiration Date
	Amount	Amount	Location	Balance Sheet	
Interest rate swap - cash flow	\$ 4,000	\$ (22)	Other Liabilities	9/15/2020	
Interest rate forward swap - cash flow	4,000	384	Other Assets	6/15/2031	
Interest rate swap - fair value	1,133	65	Other Assets	4/9/2025	
Interest rate swap - fair value	4,231	145	Other Assets	2/12/2022	

(In thousands)

Derivatives designated as hedging instruments	December 31, 2017				
	Notional/Contract	Fair Value		Fair Value	Expiration Date
	Amount	Amount	Location	Balance Sheet	
Interest rate swap - cash flow	\$ 4,000	\$ (119)	Other Liabilities	9/15/2020	
Interest rate forward swap - cash flow	4,000	164	Other Assets	6/15/2031	
Interest rate swap - fair value	1,219	20	Other Assets	4/9/2025	
Interest rate swap - fair value	4,475	49	Other Assets	2/12/2022	

#### Note 6. Earnings Per Share

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

	For the Three Months Ended				For the Nine Months Ended			
	September 30,		September 30,		September 30,		September 30,	
	2018	2017	2018	2017	2018	2017	2018	2017
	Shares	Per Share Amount	Shares	Per Share Amount	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	3,773,836	\$ 0.35	3,765,359	\$ 0.34	3,771,945	\$ 1.21	3,765,368	\$ 0.81
Effect of dilutive stock awards	6,711		8,454		7,443		8,320	
Diluted earnings per share	<u>3,780,547</u>	<u>\$ 0.35</u>	<u>3,773,813</u>	<u>\$ 0.34</u>	<u>3,779,388</u>	<u>\$ 1.21</u>	<u>3,773,688</u>	<u>\$ 0.81</u>

Non-vested restricted shares have voting rights and receive non-forfeitable dividends during the vesting period; therefore, they are included in calculating basic earnings per share. The portion of non-vested performance-based stock awards that are expected to vest, but have not yet been awarded, are included in the calculation of diluted earnings per share.

#### 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 Company's Board of Directors approved the Plan, effective March 19, 2009, with a termination date of December 31, 2019. The Company's Board of Directors may terminate, suspend or modify the Plan within certain restrictions. The Plan authorizes for issuance 350,000 shares of the Company's common stock. The Plan requires that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant. Such options are generally not exercisable until three years from the date of issuance and generally require continuous employment during the period prior to exercise. The options will expire in no more than ten years after the date of grant. The stock options, stock appreciation rights, restricted shares, and long-term performance unit awards for certain employees are generally subject to vesting requirements and are subject to forfeiture if vesting and other contractual provision requirements are not met. The Company did not grant stock options during the three and nine months ended September 30, 2018 and 2017 and there were no options outstanding at September 30, 2018 and 2017.

## Restricted Shares

The restricted shares are accounted for using the fair market value of the Company's common stock on the date the restricted shares were awarded. The restricted shares issued to certain officers are subject to a vesting period, whereby, the restrictions on the shares lapse on the third year anniversary of the date the restricted shares were awarded. Compensation expense for these shares is recognized over the three-year period. The restricted shares issued to nonemployee directors are not subject to a vesting period; however, they are subject to certain restrictions for the three-year period. Compensation expense for nonemployee directors is recognized at the date the shares are granted.

The Company has granted 7,333 and 10,525 shares of non-vested restricted stock to certain officers and 4,194 and 5,139 shares of vested restricted stock to nonemployee directors during the nine months ended September 30, 2018 and 2017, respectively. Compensation expense, net of forfeitures, for non-vested shares was \$34,000 and \$(12,000) for the three months ended September 30, 2018 and 2017, and \$99,000 and \$53,000 for the nine months ended September 30, 2018 and 2017, respectively. For the nine months ended September 30, 2018 and 2017, there was \$217,000 and \$166,000, respectively, of total unrecognized compensation expense related to these non-vested shares, which will be recorded in conjunction with the remaining vesting periods. There was no compensation expense for nonemployee directors for the three months ended September 30, 2018 and 2017. There was \$90,000 of compensation expense for nonemployee director shares for the nine months ended September 30, 2018 and 2017.

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

	September 30, 2018		September 30, 2017	
	Shares	Weighted Average Fair Value Per Share	Shares	Weighted Average Fair Value Per Share
Non-vested shares, beginning	18,062	\$ 16.44	18,045	\$ 15.04
Granted	11,527	21.47	15,664	17.50
Vested	(6,652)	21.47	(9,123)	16.74
Forfeited	(368)	21.47	(6,524)	16.24
Non-vested shares, ending	<u>22,569</u>	<u>\$ 17.98</u>	<u>18,062</u>	<u>\$ 15.88</u>

The Company granted 6,867 and 10,525 shares of performance-based stock rights with respect to certain officers during the nine months ended September 30, 2018 and 2017, respectively. The performance-based stock rights are accounted for using the fair market value of the Company's common stock on the date awarded, and adjusted as the market value of the stock changes. The performance-based stock rights are subject to a vesting period, whereby the restrictions on the shares lapse on the third year anniversary of the date the shares were awarded. Until vesting, the shares are not issued and not included in shares outstanding. The awards are subject to the Company reaching a predetermined three-year performance average on the return on average equity ratio, compared to a predetermined peer group of banks. Compensation expense for performance-based stock rights totaled \$27,000 and \$(4,000) for the three months ended September 30, 2018 and 2017, respectively, and \$67,000 and \$37,000 for the nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018 and 2017, there was \$183,000 and \$77,000 of total unrecognized compensation expense, respectively, related to non-vested share-based compensation arrangements granted under the Plan.

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

	September 30, 2018		September 30, 2017	
	Performance Based Stock Rights	Weighted Average Fair Value Per Share	Performance Based Stock Rights	Weighted Average Fair Value Per Share
Non-vested shares, beginning	18,062	\$ 16.44	18,045	\$ 15.72
Granted	6,867	21.47	10,525	17.50
Vested	-	-	-	-
Forfeited	(2,826)	21.47	(10,508)	16.05
Non-vested shares, ending	<u>22,103</u>	<u>\$ 17.90</u>	<u>18,062</u>	<u>\$ 16.58</u>

## Note 8. Employee Benefit Plans

The Company has a defined contribution retirement plan under Internal Revenue Code of 1986 ("Code") Section 401(k) covering all employees who work at least 1,000 hours per year. Under the plan, a participant may contribute an amount equal 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 6% of compensation deferred, for a maximum match of 6% of compensation. The Company makes an additional safe harbor

contribution equal to 3% of compensation to all eligible participants. The Company's 401(k) plan expenses for the three months ended September 30, 2018 and 2017 were \$177,000 and \$167,000, respectively, and were \$530,000 and \$521,000 for the nine months ended September 30, 2018 and 2017, respectively.

The Company maintains a Director Deferred Compensation Plan ("Deferred Compensation Plan"). This plan provides that any nonemployee director of the Company 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 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. No directors participated in the Deferred Compensation Plan during the three and nine months ended September 30, 2018 and 2017.

The Company has a nonqualified deferred compensation program 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 for the three and nine months ended September 30, 2018 was \$9,000 and \$36,000, respectively. Deferred compensation expense for the three and nine months ended September 30, 2017 was \$7,000 and \$7,000, respectively. Concurrent with the establishment of the deferred compensation program, 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 program. Income on these life insurance policies amounted to \$7,000 for the three months ended September 30, 2018 and 2017, and \$21,000 and for the nine months ended September 30, 2018 and 2017. The Company has recorded on its consolidated balance sheets \$1.3 million in cash surrender value of these policies at September 30, 2018 and December 31, 2017, and \$103,000 and \$93,000, respectively, in accrued liabilities.

#### **Note 9. Fair Value Measurement**

U.S. GAAP requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, effective for financial statement periods beginning after December 15, 2017. Therefore, the fair value presented herein may not be comparable to prior periods. Methodologies utilized are as follows:

- **Income Approach:** Fair value is determined based on a discounted cash flow analysis. The discounted cash flow analysis is based on the contractual maturity of the loan and market indications of rates, prepayment speeds, defaults and credit risk.
- **Asset Approach:** Fair value is determined based on the estimated values of the underlying collateral or individual analysis of receipts. This provides a better indication of value than the contractual income streams when loans are not performing or exhibit strong signs indicative of nonperformance.

Fair value has been estimated in accordance with U.S. GAAP, and is intended to represent the price that would be received in an orderly transaction between market participants as of the measurement date. In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, at least one significant assumption not observable in the market was utilized. These unobservable assumptions reflect estimates that market participants would use in pricing the asset or liability. Inputs to these valuation techniques are subjective in nature, involve uncertainties and require significant judgement and therefore cannot be determined with precision. Accordingly, the fair value estimates presented are not necessarily indicative of the amounts to be realized in a current market exchange.

U.S. GAAP also indicates that fair value estimates are presented according to a fair value hierarchy comprised of three levels. The levels are based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. The level within the fair value hierarchy for an asset or liability is based on the highest level of input that is significant to the fair value measurement (with Level 1 considered highest and Level 3 considered lowest). A brief description of each level follows:

- **Level 1:** Inputs are defined as quoted prices (unadjusted) in active markets for identical assets or liabilities.
- **Level 2:** Inputs are defined as inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.
- **Level 3:** Inputs are defined as unobservable inputs for the asset or liability.

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

**Securities available for sale:** Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data (Level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any, market activity, then the security would fall to the lowest level of the hierarchy (Level 3). The Company's investment portfolio is primarily valued using fair

value measurements that are considered to be Level 2. The Company has contracted with a third party portfolio accounting service vendor for valuation of its securities. The vendor's primary source for security valuation is Interactive Data Corporation ("IDC"), which evaluates securities based on market data. IDC utilizes evaluated pricing models that vary by asset class and include available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary models, vast descriptive terms and conditions databases, as well as extensive quality control programs.

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

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2018 and December 31, 2017 by levels within the valuation hierarchy:

(In thousands)	Fair Value Measurements			
	Balance	Level 1	Level 2	Level 3
<b>Assets at September 30, 2018:</b>				
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	\$ 57,396	\$ -	\$ 57,396	\$ -
Obligations of states and political subdivisions	14,383	-	14,383	-
Corporate bonds	850	-	850	-
Total available for sale securities	72,629	-	72,629	-
Interest rate swaps	594	-	594	-
Total assets at fair value	\$ 73,223	\$ -	\$ 73,223	\$ -
<b>Liabilities at September 30, 2018:</b>				
Interest rate swaps	\$ 22	\$ -	\$ 22	\$ -
Total liabilities at fair value	\$ 22	\$ -	\$ 22	\$ -
<b>Assets at December 31, 2017:</b>				
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	\$ 52,377	\$ -	\$ 52,377	\$ -
Obligations of states and political subdivisions	15,255	-	15,255	-
Corporate bonds	4,139	-	4,139	-
Mutual funds	382	382	-	-
Total available for sale securities	72,153	382	71,771	-
Interest rate swaps	233	-	233	-
Total assets at fair value	\$ 72,386	\$ 382	\$ 72,004	\$ -
<b>Liabilities at December 31, 2017:</b>				
Interest rate swaps	\$ 119	\$ -	\$ 119	\$ -
Total liabilities at fair value	\$ 119	\$ -	\$ 119	\$ -

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

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

Mortgage Loans Held for Sale: Mortgage loans held for sale are carried at lower of cost or market value. These loans currently consist of 1-4 family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on mortgage loans held for sale during the three and nine months ended September 30, 2018. Gains and losses on the sale of loans are recorded as a component of noninterest income on the consolidated statements of income.

Impaired Loans: A loan is designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loans or the fair value of the collateral securing the loans, or the present value of the cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing an income or market

valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statements of income.

Other Real Estate Owned ("OREO"): OREO is measured at fair value less estimated 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. The Company considers the OREO as nonrecurring Level 3.

The following table summarizes the Company's financial assets that were measured at fair value on a nonrecurring basis at September 30, 2018 and December 31, 2017.

(In thousands)	<b>September 30, 2018</b>			
	<b>Balance</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets:</b>				
Impaired loans, net	\$ 2,689	\$ -	\$ 2,568	\$ 121
Other real estate owned, net	1,356	-	-	1,356

(In thousands)	<b>December 31, 2017</b>			
	<b>Balance</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets:</b>				
Impaired loans, net	\$ 5,087	\$ -	\$ 5,041	\$ 46
Other real estate owned, net	1,356	-	-	1,356

The following table displays quantitative information about Level 3 Fair Value Measurements at September 30, 2018 and December 31, 2017.

(Dollars in thousands)	<b>September 30, 2018</b>			
	<b>Fair Value</b>	<b>Valuation Technique</b>	<b>Unobservable Input</b>	<b>Weighted Average Discount</b>
Impaired loans, net	\$ 121	Appraised values	Age of appraisal, current market conditions, experience within local market, and U.S. Government guarantees	40%
Other real estate owned, net	1,356	Appraised values	Age of appraisal, current market conditions and selling costs	18%
<b>Total</b>	<b>\$ 1,477</b>			

(Dollars in thousands)	<b>December 31, 2017</b>			
	<b>Fair Value</b>	<b>Valuation Technique</b>	<b>Unobservable Input</b>	<b>Weighted Average Discount</b>
Impaired loans, net	\$ 46	Appraised values	Age of appraisal, current market conditions, experience within local market, and U.S. Government guarantees	90%
Other real estate owned, net	1,356	Appraised values	Age of appraisal, current market conditions and selling costs	18%
<b>Total</b>	<b>\$ 1,402</b>			

The estimated fair values and related carrying amounts of the Company's financial instruments are as follows:

<b>September 30, 2018</b>					
(In thousands)	<u>Carrying Amount</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Fair Value</u>
<b>Assets</b>					
Cash and short-term investments	\$ 20,989	\$ 20,989	\$ -	\$ -	\$ 20,989
Securities available for sale	72,629	-	72,629	-	72,629
Restricted investments	2,495	-	2,495	-	2,495
Loans, net	527,802	-	-	509,568	509,568
Accrued interest receivable	1,944	-	1,944	-	1,944
Interest rate swaps	594	-	594	-	594
Bank-owned life insurance	13,505	-	13,505	-	13,505
Total financial assets	<u>\$ 639,958</u>	<u>\$ 20,989</u>	<u>\$ 91,167</u>	<u>\$ 509,568</u>	<u>\$ 621,724</u>
<b>Liabilities</b>					
Deposits	\$ 566,231	\$ -	\$ 565,159	\$ -	\$ 565,159
Federal funds purchased	5,000	-	4,997	-	4,997
FHLB advances	29,800	-	29,603	-	29,603
Junior subordinated debt	4,124	-	4,795	-	4,795
Accrued interest payable	244	-	244	-	244
Interest rate swaps	22	-	22	-	22
Total financial liabilities	<u>\$ 605,421</u>	<u>\$ -</u>	<u>\$ 604,820</u>	<u>\$ -</u>	<u>\$ 604,820</u>

<b>December 31, 2017</b>					
(In thousands)	<u>Carrying Amount</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Fair Value</u>
<b>Assets</b>					
Cash and short-term investments	\$ 29,300	\$ 29,091	\$ -	\$ -	\$ 29,091
Securities available for sale	72,153	382	71,771	-	72,153
Restricted investments	1,546	-	1,546	-	1,546
Loans, net	497,705	-	494,143	46	494,189
Accrued interest receivable	1,940	-	1,940	-	1,940
Interest rate swaps	233	-	233	-	233
Bank-owned life insurance	13,234	-	13,234	-	13,234
Total financial assets	<u>\$ 616,111</u>	<u>\$ 29,473</u>	<u>\$ 582,867</u>	<u>\$ 46</u>	<u>\$ 612,386</u>
<b>Liabilities</b>					
Deposits	\$ 570,023	\$ -	\$ 569,297	\$ -	\$ 569,297
FHLB advances	7,860	-	7,766	-	7,766
Junior subordinated debt	4,124	-	4,116	-	4,116
Accrued interest payable	128	-	128	-	128
Interest rate swaps	119	-	119	-	119
Total financial liabilities	<u>\$ 582,254</u>	<u>\$ -</u>	<u>\$ 581,426</u>	<u>\$ -</u>	<u>\$ 581,426</u>

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. U.S. GAAP 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 held for investment purposes, fair values are based on quoted market prices or dealer quotes. If quoted market prices are not available, fair values are based on quoted market prices for similar securities. Restricted securities are carried at cost based on redemption provisions of the issuers. See Note 2 “Securities” for further discussion on determining fair value for pooled trust preferred securities.

Mortgage loans held for sale: Fair value for mortgage loans held for sale is based on the price secondary markets are currently offering for similar loans.

Loans: 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., 1-4 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 value for impaired loans is described above.

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

Bank-owned life insurance: The carrying amount of life insurance contracts is assumed to be a reasonably appropriate 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.

Deposits: The fair values disclosed for demand deposits (i.e., interest and noninterest-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.

Borrowings: The fair values of the Company’s advances from the Federal Home Loan Bank of Atlanta 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 are based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2018 and December 31, 2017, the fair value of loan commitments and standby letters of credit were deemed immaterial.

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

#### **Note 10. Accumulated Other Comprehensive Income (Loss)**

Changes in accumulated other comprehensive income (loss), net of tax, for the nine months ended September 30, 2018 and 2017 were:



(In thousands)	Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Available for Sale Securities	Supplemental Executive Retirement Plans	Total
<b>Balance, December 31, 2017</b>	\$ 37	\$ (37)	\$ 125	\$ 125
Reclassification of net unrealized gains on equity securities from AOCI per ASU 2016-01	-	(10)	-	(10)
Net current-period other comprehensive income (loss)	250	(1,478)	-	(1,228)
<b>Balance, September 30, 2018</b>	<u>\$ 287</u>	<u>\$ (1,525)</u>	<u>\$ 125</u>	<u>\$ (1,113)</u>
<b>Balance, December 31, 2016</b>	\$ 17	\$ (765)	\$ 11	\$ (737)
Net current-period other comprehensive income (loss)	(4)	919	-	915
<b>Balance, September 30, 2017</b>	<u>\$ 13</u>	<u>\$ 154</u>	<u>\$ 11</u>	<u>\$ 178</u>

#### Note 11. Investment in Affordable Housing Projects

The Company has investments in certain affordable housing projects located in the Commonwealth of Virginia through seven limited liability partnerships of the Bank. These partnerships exist to develop and preserve affordable housing for low income families through residential rental property projects. The Company exerts no control over the operating or financial policies of the partnerships. Return on these investments is through receipt of tax credits and other tax benefits which are subject to recapture by taxing authorities based on compliance features at the project level. The investments are due to expire by 2035. The Company accounts for the affordable housing investments using the equity method and has recorded \$4.6 million and \$3.8 million in other assets at September 30, 2018 and December 31, 2017, respectively, and \$1.2 million in other liabilities related to unfunded capital calls through 2021 at September 30, 2018 and December 31, 2017. The related federal tax credits, included in income tax expense in the consolidated statements of income, for the nine months ended September 30, 2018 and 2017 were \$378,000 and \$353,000, respectively. There were \$62,000 in flow-through losses recorded in noninterest income during the three months ended September 30, 2018 and 2017, and \$206,000 and \$149,000 in flow-through losses for the nine months ended September 30, 2018 and 2017, respectively.

#### Note 12. Revenue Recognition

On January 1, 2018, the Company adopted ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)", and all amendments thereto (collectively, ASU 2014-09), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain/loss from the transfer of nonfinancial assets, such as other real estate owned. The Company adopted ASU 2014-09 using the modified retrospective method applied to all contracts not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under ASU 2014-09, while prior period amounts continue to be reported in accordance with pronouncements in effect prior to January 1, 2018. The adoption of ASU 2014-09 did not result in a change to the accounting for any of the in-scope revenue streams; therefore, no cumulative effect adjustment was recorded.

Most revenue associated with the Company's financial instruments, including interest income, are outside the scope of ASU 2014-09. The Company's services that fall within the scope of ASU 2014-09 are presented within noninterest income and are recognized as revenue as the Company satisfies its obligation to the customer. A description of the Company's primary revenue streams accounted for under ASU 2014-09 follows:

**Trust, estate and brokerage fee income:** Income is primarily comprised of fees earned from the management and administration of trusts, estates and other customer assets and by providing investment brokerage services. Fees that are transaction-based (e.g., execution of trades) are recognized on a monthly basis. Other fees, or commissions, are earned over time as the contracted monthly or quarterly services are provided and are generally assessed based on either account activity or the market value of assets under management at month end.

**Service charges on deposit accounts:** The Company earns fees from its deposit customers for overdraft and account maintenance services. Overdraft fees are recognized when the overdraft occurs. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. The Company also earns fees from its customers for transaction-based services. Such services include safe deposit box, ATM, stop payment and wire transfer fees. In each case, these service charges and fees are recognized in income at the time or within the same period that the Company's performance obligation is satisfied.

**Interchange fee income, net:** The Company earns interchange fees from debit and credit cardholder transactions conducted through various payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services.

Noninterest income by major source, for the three and nine months ended September 30, 2018 and 2017, consisted of the following:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
<b>Noninterest income</b>				
Trust and estate fees <sup>(1)</sup>	\$ 379	\$ 379	\$ 1,154	\$ 1,151
Brokerage fees <sup>(1)</sup>	45	38	132	129
Service charges on deposit accounts <sup>(1)</sup>	413	467	1,261	1,452
Interchange fee income, net <sup>(1)</sup>	319	302	931	923
Bank-owned life insurance	91	91	271	271
Other service charges, commissions and other income <sup>(2)</sup>	44	11	168	167
Gain on call of securities available for sale	-	1	838	1
Gain on sale of mortgage loans held for sale, net	33	1	56	1
<b>Total noninterest income</b>	<b>\$ 1,324</b>	<b>\$ 1,290</b>	<b>\$ 4,811</b>	<b>\$ 4,095</b>

(1) Income within scope of Accounting Standards Codification (“ASC”) 606.

(2) Income within the scope of ASC 606 of \$102,000 for the three months ended September 30, 2018 and 2017, and \$239,000 for the nine months ended September 30, 2018 and 2017. The remaining balancing is outside the scope of ASC 606.

## 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 the Company believes its plans, intentions and expectations reflected in these forward-looking statements are reasonable, the Company can give no assurance that these plans, intentions, or expectations will be achieved. The Company's 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 the Company's 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 "Federal Reserve"), the quality or composition of the loan or investment portfolios, the value of the collateral securing loans in the portfolio, demand for loan products, deposit flows, the level of net charge-offs on loans and the adequacy of the allowance for loan losses, competition, demand for financial services in the Company's market area, the Company's plans to increase market share, mergers, acquisitions and dispositions, and tax 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 the Company's 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 Bank has 11 full service branch offices located in the Virginia communities of Old Town-Warrenton, Warrenton, Catlett, The Plains, Sudley Road-Manassas, New Baltimore, Bealeton, Bristow, Haymarket, Gainesville, and Centreville Road-Manassas. 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, Prince William County, and neighboring communities and is located approximately 50 miles southwest of Washington, D.C.

The basic services offered by the Bank include: interest and noninterest-bearing demand deposit accounts, money market deposit accounts, NOW accounts, time deposits, safe deposit services, automated teller machines ("ATM"), debit and credit cards, cash management, direct deposits, notary services, night depository, cashier's checks, domestic and international collections, automated teller services, drive-in tellers, mobile and internet banking, telephone banking, and banking by mail. In addition, the Bank makes secured and unsecured commercial and real estate loans, issues stand-by letters of credit and grants available credit for installment, unsecured and secured personal loans, residential mortgages and home equity loans, as well as, automobile and other types of consumer financing. The deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"). The Bank provides 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 certificates of deposit investments and deposit sweeps through the transfer and/or exchange with other FDIC insured institutions. CDARS and ICS are registered trademarks 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. This division provides personalized services including investment management, financial planning, trust, estate settlement, retirement, insurance, and brokerage services.

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

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

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 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.

## CRITICAL ACCOUNTING POLICIES

**GENERAL.** The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The financial information contained within the Company's 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. The Company uses historical loss factors as one factor in determining the inherent loss that may be present in its loan portfolio. Actual losses could differ significantly from the historical factors that the Company uses in its estimates. In addition, U.S. 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 the recognition of 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 the Company's loan portfolio. The allowance is based on three basic accounting principles: (i) Accounting Standards Codification ("ASC") 450 "Contingencies", which requires losses to be accrued when they are probable of occurring and estimable, (ii) ASC 310 "Receivables", which requires 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 (the "SEC"), Staff Accounting Bulletin No. 102, "Selected Loan Loss Allowance Methodology and Documentation Issues", which requires adequate documentation to support the allowance for loan losses estimate.

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

Specifically, the Company uses both external and internal qualitative factors when determining the non-loan-specific allowances. The external factors utilized include: unemployment in the Company's defined market area of Fauquier County, Prince William County, and the City of Manassas ("market area"), as well as state and national unemployment trends; new residential construction permits for the market area; bankruptcy statistics for the region and 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*, 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: past due loan 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 twelve 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.

**OTHER-THAN-TEMPORARY IMPAIRMENT ("OTTI") FOR SECURITIES.** Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if

either (i) the Company intends to sell the security or (ii) it is more-likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more-likely-than-not that the Company will be required to sell the security before recovery, the Company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no OTTI. If there is a credit loss, OTTI exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss). For equity securities, impairment is considered to be other-than-temporary based on the Company's ability and intent to hold the investment until a recovery of fair value. OTTI of an equity security results in a write-down that must be included in net income. The Company regularly reviews each investment security for OTTI based on criteria that includes the extent to which cost exceeds market price, the duration of any market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, the intention with regard to holding the security to maturity and the likelihood that the Company would be required to sell the security before recovery.

## **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 the Company's 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 Company strives to be a top performing community bank by providing financial services in its market including consistent quality customer service, premier technological support, value-added products, a strong commitment to the community and enhancing shareholder value.

Net income increased to \$1.3 million, or \$0.35 per diluted share, for the third quarter of 2018, relatively equal to net income for the third quarter of 2017, with an increase in per diluted share from \$0.34. Net income increased to \$4.6 million for the nine months ended September 30, 2018, or \$1.21 per diluted share, from \$3.0 million, or \$0.81 per diluted share, for the nine months ended September 30, 2017.

As of September 30, 2018, the Company had total assets of \$670.0 million compared with \$644.6 million at December 31, 2017. Loans, net of the allowance for loan losses, increased to \$527.8 million at September 30, 2018, or \$30.1 million from \$497.7 million at December 31, 2017. Deposits, totaling \$566.2 million at September 30, 2018, decreased \$3.8 million when compared with December 31, 2017 of \$570.0 million. Assets under WMS management, totaling \$305.0 million in market value at September 30, 2018, compared with \$297.7 million at December 31, 2017.

Net interest income is the largest component of net income, and is 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 nonperforming assets, the amount of prepaying loans, the mix and amount of various deposit types, competition for loans and deposits, and many other factors. 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 Bank's nonperforming assets totaled \$9.0 million or 1.34% of total assets at September 30, 2018, compared with \$10.4 million or 1.61% of total assets at December 31, 2017. Nonaccrual loans totaled \$2.4 million or 0.45% of total loans at September 30, 2018 compared with \$3.2 million or 0.63% of total loans at December 31, 2017. The allowance for loan losses was \$5.2 million or 0.98% of total loans at September 30, 2018 compared with \$5.1 million or 1.01% of total loans at December 31, 2017.

## **OPERATING RESULTS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017**

### **NET INCOME**

Net income was \$1.3 million, or \$0.35 per diluted share, for the quarter ended September 30, 2018, relatively equal to net income for the third quarter of 2017, with an increase in per diluted share from \$0.34. Net income for the nine months ended September 30, 2018 was \$4.6 million, or \$1.21 per diluted share, compared with \$3.0 million, or \$0.81 per diluted share, for the nine months ended September 30, 2017. Profitability as measured by return on average assets and return on average equity increased to 0.79% and 8.96%, respectively, for the third quarter of 2018 from 0.80% and 8.96%, respectively, for the third quarter of 2017. Profitability as measured by return on average assets and return on average equity increased to 0.93% and 10.66%, respectively, for the nine months ended September 30, 2018 compared with 0.65% and 7.27%, respectively, for the nine months ended September 30, 2017.

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

Net interest income increased \$355,000 or 6.47% to \$5.8 million for the quarter ended September 30, 2018 from \$5.5 million for the quarter ended September 30, 2017. For the quarter ended September 30, 2018, net interest income increased 11.36% to \$17.4 million from \$15.6 million, for the quarter ended September 30, 2017. The Company's net interest margin increased to 3.81% in the third quarter of 2018 from 3.75% in the

third quarter of 2017. For the nine months ended September 30, 2018 and 2017, the Company's net interest margin was 3.81% and 3.62%, respectively.

Interest income increased \$693,000 or 11.55% to \$6.7 million for the third quarter of 2018 from \$6.0 million for the third quarter of 2017. Interest income increased 14.45% to \$19.6 million for the nine months ended September 30, 2018 from \$17.1 million for the nine months ended September 30, 2017. This increase was due to higher average balances and yields on earning assets for the three and nine months ended September 30, 2018 compared with the three and nine months ended September 30, 2017. The yield on earning assets increased 28 basis points from 4.09% during the third quarter of 2017 to 4.37% during the third quarter of 2018 and increased 32 basis points from 3.97% for the nine months ended September 30, 2017 to 4.29% for the nine months ended September 30, 2018. The changes in earning assets were:

- Average balances for loans increased \$40.6 million from \$479.2 million for the third quarter of 2017 to \$519.7 million for the third quarter of 2018, and increased \$46.2 million from \$464.1 million for the nine months ended September 30, 2017 to \$510.3 million for the nine months ended September 30, 2018. As a result of increasing balances, the Company's loan pricing strategies and the current interest rate environment, the tax equivalent yield increased 14 basis points to 4.66% for the third quarter of 2018, compared with 4.52% for the third quarter of 2017, and increased 18 basis points to 4.67% for the nine months ended September 30, 2018 from 4.49% for the nine months ended September 30, 2017.
- Average balances for securities increased \$9.4 million from \$66.9 million for the third quarter of 2017 to \$76.3 million for the third quarter of 2018, and increased \$13.7 million from \$61.0 million for the nine months ended September 30, 2017 to \$74.6 million for the nine months ended September 30, 2018. The tax equivalent yield increased from 2.83% for the third quarter of 2017 to 2.94% for the third quarter of 2018, and decreased from 2.85% for the nine months ended September 30, 2017 to 2.79% for the nine months ended September 30, 2018. The yield in securities decreased primarily due to calls and maturities on higher yielding securities held in the portfolio. Management continues to invest, in accordance with the Company's investment policy, in securities that strengthen the Company's liquidity position, manage interest rate risk and provide earnings.
- Average balances for deposits in other banks decreased to \$14.8 million for the third quarter of 2018 from \$41.5 million for the third quarter of 2017, and decreased to \$28.6 million for the nine months ended September 30, 2018 from \$58.0 million for the nine months ended September 30, 2017. This decline was the result of lower balances at the Federal Reserve Bank of Richmond ("FRB") due to lower requirements and to provide funding for higher earnings assets.

Interest expense increased \$338,000 or 65.63% from \$515,000 for the third quarter of 2017 to \$853,000 for the third quarter of 2018. Interest expense increased 46.75% to \$2.2 million for the nine months ended September 30, 2018 from \$1.5 million for the nine months ended September 30, 2017. These increases were primarily due to increases in volume and average rates paid for interest-bearing deposit accounts and FHLB advances. The average rate on total interest-bearing liabilities increased to 0.71% for the third quarter of 2018 from 0.45% for the third quarter of 2017 and increased to 0.61% for the nine months ended September 30, 2018 from 0.44% for the nine months ended September 30, 2017.

- Average balances for deposits increased \$3.8 million from \$443.4 million for the third quarter of 2017 to \$447.2 million for the third quarter of 2018, and increased \$11.2 million from \$438.4 million for the nine months ended September 30, 2017 to \$449.6 million for the nine months ended September 30, 2018. Interest paid on deposits increased \$222,000 or 53.75% from \$413,000 for the third quarter of 2017 to \$635,000 for the third quarter of 2018. Interest paid on deposits increased 42.41% to \$1.6 million for the nine months ended September 30, 2018 from \$1.1 million for the nine months ended September 30, 2017.
- Average balances for federal funds purchased and FHLB advances increased \$17.4 million from \$7.9 million for the third quarter of 2017 to \$25.3 million for the third quarter of 2018, and increased \$14.7 million from \$10.5 million for the nine months ended September 30, 2017 to \$25.2 million for the nine months ended September 30, 2018. Interest expense on federal funds purchased and FHLB advances was \$167,000 and \$51,000 for the third quarter of 2018 and 2017, respectively. Interest expense on federal funds purchased and FHLB advances was \$411,000 and \$198,000 for the nine months ended September 30, 2018 and 2017, respectively. These increases were due to the Company's funding needs during the periods.

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

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

**For the Three Months Ended**

**For the Three Months Ended**

**September 30, 2018**

**September 30, 2017**

(Dollars in thousands)

<b>Assets</b>	<b>Average Balances</b>	<b>Income/ Expense</b>	<b>Average Rate</b>	<b>Average Balances</b>	<b>Income/ Expense</b>	<b>Average Rate</b>
<b>Loans</b>						
Taxable	\$ 517,148	\$ 6,110	4.69%	\$ 474,583	\$ 5,437	4.55%
Tax-exempt (1)	—	—	—	2,129	27	5.29%
Nonaccrual (2)	2,574	—	—	2,449	—	—
<b>Total loans</b>	<b>519,722</b>	<b>6,110</b>	<b>4.66%</b>	<b>479,161</b>	<b>5,464</b>	<b>4.52%</b>
<b>Securities</b>						
Taxable	62,241	438	2.81%	53,035	329	2.48%
Tax-exempt (1)	14,071	118	3.36%	13,874	144	4.16%
<b>Total securities</b>	<b>76,312</b>	<b>556</b>	<b>2.91%</b>	<b>66,909</b>	<b>473</b>	<b>2.83%</b>
Deposits in other banks	14,778	53	1.42%	41,505	122	1.17%
Federal funds sold	15	—	1.87%	10	—	1.10%
<b>Total earning assets</b>	<b>610,827</b>	<b>6,719</b>	<b>4.37%</b>	<b>587,585</b>	<b>6,059</b>	<b>4.09%</b>
Less: Allowance for loan losses	(5,145)			(4,413)		
Total nonearning assets	51,996			50,515		
<b>Total Assets</b>	<b>\$ 657,678</b>			<b>\$ 633,687</b>		
<b>Liabilities and Shareholders' Equity</b>						
<b>Deposits</b>						
Demand	\$ 116,376			\$ 115,303		
<b>Interest-bearing</b>						
NOW	223,231	\$ 228	0.41%	230,629	\$ 161	0.28%
Money market	62,667	102	0.65%	54,830	29	0.21%
Savings	89,728	68	0.30%	88,669	34	0.15%
Time	71,547	237	1.31%	69,227	189	1.09%
<b>Total interest-bearing deposits</b>	<b>447,173</b>	<b>635</b>	<b>0.56%</b>	<b>443,355</b>	<b>413</b>	<b>0.37%</b>
Federal funds purchased	2,728	16	2.29%	0	—	0.00%
FHLB advances	22,570	152	2.66%	7,888	52	2.58%
Junior subordinated debt	4,124	50	4.83%	4,124	50	4.83%
<b>Total interest-bearing liabilities</b>	<b>476,595</b>	<b>853</b>	<b>0.71%</b>	<b>455,367</b>	<b>515</b>	<b>0.45%</b>
Other liabilities	6,436			6,266		
Shareholders' equity	58,271			56,751		
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>\$ 657,678</b>			<b>\$ 633,687</b>		
Net interest income (tax equivalent basis)		\$ 5,866	3.66%		\$ 5,544	3.64%
Less: tax equivalent adjustment		(25)			(58)	
<b>Net interest income</b>		<b>\$ 5,841</b>			<b>\$ 5,486</b>	
Interest expense as a percent of average earning assets			0.55%			0.35%
Net interest margin			3.81%			3.75%

(1) Income and rates on non-taxable assets are computed on a tax-equivalent basis using a federal tax rate of 21% and 34% for 2018 and 2017, respectively.

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

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

(Dollars in thousands)	For the Nine Months Ended September 30, 2018			For the Nine Months Ended September 30, 2017		
	Average Balances	Income/ Expense	Average Rate	Average Balances	Income/ Expense	Average Rate
<b>Assets</b>						
<b>Loans</b>						
Taxable	\$ 507,332	\$ 17,813	4.69%	\$ 458,300	\$ 15,463	4.51%
Tax-exempt (1)	—	—	—	2,766	108	5.29%
Nonaccrual (2)	2,961	—	—	3,007	—	—
Total loans	<u>510,293</u>	<u>17,813</u>	<u>4.67%</u>	<u>464,073</u>	<u>15,571</u>	<u>4.49%</u>
<b>Securities</b>						
Taxable	60,496	1,196	2.64%	49,950	927	2.48%
Tax-exempt (1)	14,139	357	3.37%	11,033	376	4.55%
Total securities	<u>74,635</u>	<u>1,553</u>	<u>2.77%</u>	<u>60,983</u>	<u>1,303</u>	<u>2.85%</u>
Deposits in other banks	28,595	313	1.46%	57,973	420	0.97%
Federal funds sold	13	—	1.66%	10	—	0.89%
Total earning assets	<u>613,536</u>	<u>19,679</u>	<u>4.29%</u>	<u>583,039</u>	<u>17,294</u>	<u>3.97%</u>
Less: Allowance for loan losses	(5,307)			(4,533)		
Total nonearning assets	<u>50,733</u>			<u>50,762</u>		
Total Assets	<u>\$ 658,962</u>			<u>\$ 629,268</u>		
<b>Liabilities and Shareholders' Equity</b>						
<b>Deposits</b>						
Demand	\$ 116,988			\$ 113,880		
Interest-bearing						
NOW	230,973	\$ 604	0.35%	231,020	\$ 463	0.27%
Money market	57,738	198	0.46%	54,360	85	0.21%
Savings	89,373	158	0.24%	86,661	84	0.13%
Time	71,547	671	1.26%	66,393	515	1.04%
Total interest-bearing deposits	<u>449,631</u>	<u>1,631</u>	<u>0.49%</u>	<u>438,434</u>	<u>1,147</u>	<u>0.35%</u>
Federal funds purchased	2,458	40	2.15%	3	—	1.41%
FHLB advances	22,694	371	2.19%	10,489	198	2.53%
Junior subordinated debt	4,124	149	4.83%	4,124	148	4.83%
Total interest-bearing liabilities	<u>478,907</u>	<u>2,191</u>	<u>0.61%</u>	<u>453,050</u>	<u>1,493</u>	<u>0.44%</u>
Other liabilities	5,873			6,476		
Shareholders' equity	<u>57,194</u>			<u>55,862</u>		
Total Liabilities & Shareholders' Equity	<u>\$ 658,962</u>			<u>\$ 629,268</u>		
Net interest income (tax equivalent basis)		\$ 17,488	3.68%	\$ 15,801		3.53%
Less: tax equivalent adjustment		(75)		(165)		
Net interest income		<u>\$ 17,413</u>		<u>\$ 15,636</u>		
Interest expense as a percent of average earning assets			0.48%			0.34%
Net interest margin			3.81%			3.62%

(1) Income and rates on non-taxable assets are computed on a tax equivalent basis using a federal tax rate of 21% and 34% for 2018 and 2017, respectively.

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



## RATE VOLUME ANALYSIS

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

(In thousands)	<b>For the Three Months Ended September 30, 2018 Compared to September 30, 2017</b>		
	<b>Change</b>	<b>Due to Volume</b>	<b>Due to Rate</b>
<b>Interest Income</b>			
Loans; taxable	\$ 672	\$ 487	\$ 185
Loans; tax-exempt <sup>(1)</sup>	(27)	(27)	-
Securities; taxable	109	58	51
Securities; tax-exempt <sup>(1)</sup>	(26)	2	(28)
Deposits in other banks	(69)	(79)	10
Total Interest Income	<u>659</u>	<u>441</u>	<u>218</u>
<b>Interest Expense</b>			
NOW	68	(5)	73
Money market	73	4	69
Savings	34	-	34
Time	47	6	41
Federal funds purchased	16	16	-
FHLB advances	99	96	3
Total Interest Expense	<u>337</u>	<u>117</u>	<u>220</u>
Net Interest Income	<u>\$ 322</u>	<u>\$ 324</u>	<u>\$ (2)</u>

<sup>(1)</sup> Income and rates on non-taxable assets are computed on a tax equivalent basis using a federal tax rate of 21% and 34% for 2018 and 2017, respectively.

(In thousands)	<b>For the Nine Months Ended September 30, 2018 Compared to September 30, 2017</b>		
	<b>Change</b>	<b>Due to Volume</b>	<b>Due to Rate</b>
<b>Interest Income</b>			
Loans; taxable	\$ 2,344	\$ 1,654	\$ 690
Loans; tax-exempt <sup>(1)</sup>	(108)	(108)	-
Securities; taxable	275	196	79
Securities; tax-exempt <sup>(1)</sup>	(20)	105	(125)
Deposits in other banks	(107)	(213)	106
Total Interest Income	<u>2,384</u>	<u>1,634</u>	<u>750</u>
<b>Interest Expense</b>			
NOW	144	-	144
Money market	113	5	108
Savings	74	3	71
Time	156	40	116
Federal funds purchased	40	-	40
FHLB advances	172	229	(57)
Total Interest Expense	<u>699</u>	<u>277</u>	<u>422</u>
Net Interest Income	<u>\$ 1,685</u>	<u>\$ 1,357</u>	<u>\$ 328</u>

<sup>(1)</sup> Income and rates on non-taxable assets are computed on a tax equivalent basis using a federal tax rate of 21% and 34% for 2018 and 2017, respectively.

## PROVISION FOR LOAN LOSSES

The provision for loan losses was \$195,000 for the third quarter of 2018 compared to \$110,000 for the third quarter of 2017, and was \$507,000 and \$395,000 for the nine months ended September 30, 2018 and 2017, respectively. Changes to provision expense were due to portfolio growth, historical net charge-off history, asset quality indicators, impaired loans and other qualitative factors.

The amount of the provision for loan loss is based upon management's 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 nonperforming loans, estimated values of collateral, and the impact of economic conditions. The loss history and prolonged changes in portfolio delinquency trends by loan category, and changes in economic trends are also considered in determining the allowance. 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.

## NONINTEREST INCOME

Noninterest income increased \$34,000 or 2.64% to \$1.3 million for the third quarter of 2018 from the third quarter of 2017. Noninterest income increased 17.56% to \$4.8 million for the nine months ended September 30, 2018, from \$4.1 million for the nine months ended September 30, 2017. The following summarizes noninterest income for the three and nine months ended September 30, 2018 and 2017:

(In thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
	<b>Noninterest income</b>			
Trust and estate fees	\$ 379	\$ 379	\$ 1,154	\$ 1,151
Brokerage fees	45	38	132	129
Service charges on deposit accounts	413	467	1,261	1,452
Interchange fee income, net	319	302	931	923
Bank-owned life insurance	91	91	271	271
Other service charges, commissions and other income	44	11	168	167
Gain on call of securities available for sale	-	1	838	1
Gain on sale of mortgage loans held for sale, net	33	1	56	1
<b>Total noninterest income</b>	<b>\$ 1,324</b>	<b>\$ 1,290</b>	<b>\$ 4,811</b>	<b>\$ 4,095</b>

The primary changes in noninterest income were:

- Service charges on deposit accounts decreased \$54,000 for the third quarter of 2018 when compared with the third quarter of 2017, and decreased \$191,000 for the nine months ended September 30, 2018 when compared to the nine months ended September 30, 2017. This decrease has been occurring over several periods and was attributable to changes in customer behavior and funds management as a result of greater access to account information via multiple technology channels.
- Other service charges, commissions and fees increased \$33,000 for the third quarter of 2018 when compared with the third quarter of 2017. The increase in quarterly income was the result of a one-time buyout payment from the Bank's previous provider of merchant card services. Other service charges, commissions and fees remained relatively unchanged for the nine months ended September 30, 2018 when compared to the nine months ended September 30, 2017.
- The call of two pooled trust preferred securities resulted in gains of \$838,000 for the nine months ended September 30, 2018 compared with the nine months ended September 30, 2017.
- Gains of \$33,000 on mortgage loans held for sale was recognized for the third quarter of 2018, and \$56,000 for the nine months ended September 30, 2018. The Company began originating and selling qualifying residential mortgage loans on the secondary market in the third quarter of 2017.

## NONINTEREST EXPENSE

Noninterest expense was \$5.5 million and \$5.0 million for the third quarter of 2018 and 2017, respectively, an increase of \$487,000 or 9.74%. Noninterest expense increased 6.27% to \$16.5 million for the nine months ended September 30, 2018 from \$15.6 million for the nine months ended September 30, 2017. The following summarizes noninterest expense for the three and nine months ended September 30, 2018 and 2017:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
<b>Noninterest Expenses</b>				
Salaries and benefits	\$ 2,999	\$ 2,683	\$ 8,937	\$ 8,271
Occupancy	599	568	1,770	1,750
Furniture and equipment	243	252	760	898
Marketing	190	142	468	378
Legal, audit and consulting	263	263	763	809
Data processing	360	298	961	942
Federal Deposit Insurance Corporation	86	84	279	225
Other operating expenses	744	708	2,601	2,290
<b>Total noninterest expenses</b>	<b>\$ 5,484</b>	<b>\$ 4,998</b>	<b>\$ 16,539</b>	<b>\$ 15,563</b>

The primary changes in noninterest expense were:

- Salaries and benefits increased \$316,000 for the third quarter of 2018 compared with the third quarter of 2017. Salaries and benefits increased \$666,000 for the nine months ended September 30, 2018 when compared to the nine months ended September 30, 2017. These changes were primarily the result of increased incentives and commissions in 2018 and reduced share-based compensation in 2017.
- Occupancy expense increased \$31,000 and \$20,000 for the three and nine months ended September 30, 2018, respectively, compared with the same periods in 2017. Furniture and equipment expense decreased \$9,000 and \$138,000 for the three and nine months ended September 30, 2018, respectively, compared to the same periods in 2017. These decreases in expenses were the result of management's initiative to manage and control expenses.
- Marketing expense increased \$48,000 and \$90,000 for the three and nine months ended September 30, 2018, respectively, compared with the same periods in 2017. These increases were primarily due to marketing initiatives to attract new business in the Company's operating footprint.
- Legal, auditing and consulting expense was unchanged for the third quarter of 2018 and decreased \$46,000 for the nine months ended September 30, 2018 compared with the same periods in 2017. These expenses decreased for the nine months ended September 30, 2018 due to less loan related legal expenses for the comparable periods. Legal expenses were higher in 2017 due to expenses related to loans charged-off in prior years.
- Data processing expense increased \$62,000 for the third quarter of 2018 and increased \$19,000 for the nine months ended September 30, 2018 compared with the same periods in 2017. Increases in expenses were due primarily to new technology, in particular online delivery, offset by improved management of expenses.
- FDIC deposit insurance premium expense increased \$2,000 and \$54,000 for third quarter of 2018 and the nine months ended September 30, 2018, respectively, compared with the same periods in 2017 due to changes in the assessment rate on higher deposits.
- Other operating expenses increased \$37,000 and \$311,000 for the three and nine months ended September 30, 2018, respectively, compared with the same periods in 2017. The majority of these increases were due to increases in loan related operating expenses, employee training and education and non-loan related net charge offs.

## INCOME TAXES

Income tax expense was \$169,000 and \$387,000 for the three months ended September 30, 2018 and 2017, respectively, resulting in an effective tax rate of 11.38% and 23.19%, respectively. Income tax expense was \$616,000 and \$734,000 for the nine months ended September 30, 2018 and 2017, respectively, resulting in an effective tax rate of 11.90% and 19.45%, respectively. The Tax Cuts and Jobs Act was signed into law on December 22, 2017, which reduced the Company's corporate tax rate from 34% to 21%, beginning January 1, 2018. The effective tax rate differed from the statutory federal income tax rate due to the Bank's investment in tax-exempt loans and securities, income from the bank-owned life insurance policies, and community development tax credits. The Company's estimated tax credits were \$378,000 and \$353,000 for nine months ended September 30, 2018 and 2017, respectively.

## FINANCIAL CONDITION AT SEPTEMBER 30, 2018 AND DECEMBER 31, 2017

Total assets increased \$25.4 million to \$670.0 million at September 30, 2018 compared with \$644.6 million at December 31, 2017. Total liabilities increased \$23.2 million to \$611.7 million compared with \$588.5 million at December 31, 2017. Total shareholders' equity increased \$2.1 million to \$58.3 million compared with \$56.1 million at December 31, 2017.

- Cash and cash equivalents decreased \$8.3 million primarily due to the decrease in funds held at the FRB because of a reduction in the minimum reserve requirement for the period.
- Securities available for sale increased \$476,000 due to liquidity positioning during the period.
- Restricted investments increased \$949,000 due to stock position requirements at the FHLB based on borrowing balances.
- Net loans increased \$30.1 million due to loan growth, primarily in the commercial and residential real estate portfolios.

- Other assets increased \$2.2 million primarily due to the Company's additional investment of \$1.0 million in a new affordable housing projects and valuation adjustments for deferred taxes within the securities portfolio and the interest rate swap on the Company's subordinated debt.
- Total deposits decreased \$3.8 million. Growth in savings and money market accounts were more than offset by the decline in noninterest-bearing and interest-bearing checking accounts and time deposits, primarily due to balance fluctuations in the Company's public deposit accounts and overall challenges in deposit growth due to rising interest rates, local competition and deposit alternatives.
- Total FHLB advances and federal funds purchased increased \$26.9 million. This increase was due, in part, to fund loan growth.
- Total shareholders' equity increased \$2.1 million, primarily due to growth in net income.

## ASSET QUALITY

Nonperforming assets, which include nonperforming loans and other real estate owned, were \$9.0 million at September 30, 2018 compared with \$10.4 million at December 31, 2017. Factors contributing to the changes in nonperforming assets were:

- Nonaccrual loans were \$2.4 million compared with \$3.2 million at December 31, 2017. The changes in nonaccrual loans include the disposition of one nonaccrual loan through foreclosure. This loan was subsequently purchased during the same period by a third party. Loans are placed on nonaccrual 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 nonaccrual loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction to the loan principal balance.
- Student loans that were greater than 90 days past due and still accruing interest totaled \$1.4 million at September 30, 2018 compared with \$1.6 million at December 31, 2017. These loans continue to accrue interest when past due because repayment of both principal and accrued interest are 98% guaranteed by the U.S. Department of Education.
- Loans greater than 90 days past due and still accruing interest totaled \$441,000 at September 30, 2018 compared with \$49,000 at December 31, 2017. The past due loans for the current period consisted of two residential real estate loans whose status was not related to credit quality.
- Restructured loans that are not on nonaccrual status totaled \$3.4 million at September 30, 2018 compared with \$4.2 million at December 31, 2017. There were no loans modified as troubled debt restructures ("TDRs") during the three and nine months ended September 30, 2018. There were no defaults on TDRs occurring within 12 months of modification during the three and nine months ended September 30, 2018 and 2017. At September 30, 2018, there were six loans in the portfolio, totaling \$3.5 million, that have been identified as TDRs, of which five were current and performing in accordance with the modified terms.

The allowance for loan losses increased from \$5.1 million at December 31, 2017 to \$5.2 million at September 30, 2018 and was primarily related to the \$30.1 million growth in net loans.

The following table sets forth certain information with respect of the Company's nonperforming assets:

(Dollars in thousands)	<b>September 30, 2018</b>	<b>December 31, 2017</b>
Nonaccrual loans	\$ 2,381	\$ 3,180
Restructured loans still accruing	3,402	4,182
Student loans greater than 90 days past due and accruing	1,400	1,616
Loans greater than 90 days past due and accruing	441	49
<b>Total nonperforming loans</b>	<b>7,624</b>	<b>9,027</b>
Other real estate owned, net	1,356	1,356
<b>Total nonperforming assets</b>	<b>\$ 8,980</b>	<b>\$ 10,383</b>
Allowance for loan losses	\$ 5,214	\$ 5,094
Allowance for loan losses to total loans	0.98%	1.01%
Nonaccrual loans to total loans	0.45%	0.63%
Allowance for loan losses to nonperforming loans	68.39%	56.43%
Nonperforming loans to total loans	1.43%	1.80%
Nonperforming assets to total assets	1.34%	1.61%

## CAPITAL

One of management's strategic objectives is to continue to increase the Company's shareholders' return on equity while maintaining a strong capital base. The Company and the Bank are subject to various capital requirements administered by bank regulatory 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 Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. 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, required the Bank to maintain minimum amounts and ratios of Total capital 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).

As of September 30, 2018 and December 31, 2017, management believes the Bank satisfies all capital adequacy requirements to which it was subject and is considered "well capitalized" as defined by the regulatory authorities. The following table provides information on the regulatory capital ratios for the Bank at September 30, 2018 and December 31, 2017. Management believes that the Bank's capital structure is strong and exceeds all capital adequacy requirements, at September 30, 2018.

(Dollars in thousands)	<u>September 30, 2018</u>	<u>December 31, 2017</u>
Tier 1 Capital:		
Common equity	\$ 61,501	\$ 59,334
Unrealized loss on securities available for sale, net	1,523	30
Unrealized benefit obligation for supplemental retirement plans	(124)	(104)
Total Common equity tier 1 capital	<u>62,900</u>	<u>59,260</u>
Tier 2 Capital:		
Allowable allowance for loan losses	<u>5,214</u>	<u>5,094</u>
Total Capital:	<u>\$ 68,114</u>	<u>\$ 64,354</u>
Risk Weighted Assets:	<u>\$ 537,667</u>	<u>\$ 518,562</u>
Regulatory Capital Ratios:		
Leverage Ratio	9.56%	9.17%
Common Equity Tier 1 Capital Ratio	11.70%	11.43%
Tier 1 Capital Ratio	11.70%	11.43%
Total Capital Ratio	12.67%	12.41%

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 current 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 previously discussed, banking regulations have established minimum capital requirements for financial institutions, including risk-based capital ratios and leverage ratios.

## LIQUIDITY

Liquidity management involves meeting the present and future financial obligations of the Company with the sale or maturity of assets or with the occurrence of additional liabilities. Liquidity needs are met with cash on hand, deposits in other banks, federal funds sold, unpledged securities and loans maturing within one year. At September 30, 2018, liquid assets totaled \$209.2 million, or 31.2%, of total assets and 34.2% of total liabilities. Securities provide a constant source of liquidity through paydowns and maturities. Also, the Company maintains short-term borrowing arrangements, namely federal funds lines of credit, with larger financial institutions as an additional source of liquidity. The Bank's membership with the FHLB also provides a source of borrowings with numerous rate and term structures. Management monitors the liquidity position regularly and attempts to maintain a position, which utilizes available funds most efficiently. As a result of the Company's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Company maintains overall liquidity sufficient to satisfy its depositors' requirements and meet its customers' credit needs.

## CONTRACTUAL OBLIGATIONS

As of September 30, 2018, there have been no 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, 2017.

## **OFF-BALANCE SHEET ARRANGEMENTS**

As of September 30, 2018, 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, 2017.

## **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 the Company’s performance than inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

## **CHANGES IN ACCOUNTING PRINCIPLES**

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

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

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

There have been no material changes to the quantitative and qualitative disclosures made in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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

#### **Disclosure Controls and Procedures**

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

The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. There have not been any significant changes in the Company's internal control over financial reporting or in other factors that have materially affected or are reasonably likely to materially affect, such controls during the quarter ended September 30, 2018.

## **Part II. OTHER INFORMATION**

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

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

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

Not required for smaller reporting companies.

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

On January 18, 2018, the Company's Board of Directors authorized the Company to repurchase up to 112,880 shares (3% of common stock outstanding on January 1, 2018) beginning January 1, 2018 and continuing until the next Board reset. During the nine months ended September 30, 2018, 368 shares of common stock were repurchased at an average price of \$21.47 per share. Under the share repurchase program, the Company has the remaining authority to repurchase up to 112,512 shares of the Company's common stock as of September 30, 2018.

Repurchases may be made through open market purchases or in privately negotiated transactions, and shares repurchased will be returned to the status of authorized and unissued shares of common stock. The actual timing, number, and value of shares repurchased under the program will be determined by management.

No repurchases of the Company's common stock occurred during the three months ended September 30, 2018.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

### **ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

## ITEM 5. OTHER INFORMATION

None.

## ITEM 6. EXHIBITS

The following exhibits are filed as part of this report and this list includes the Exhibit Index.

<b>Exhibit Number</b>	<b>Exhibit Description</b>
31.1	<a href="#">Certification of CEO pursuant to Rule 13a-14(a).</a>
31.2	<a href="#">Certification of CFO pursuant to Rule 13a-14(a).</a>
32.1	<a href="#">Certification of CEO pursuant to 18 U.S.C. Section 1350.</a>
32.2	<a href="#">Certification of CFO pursuant to 18 U.S.C. Section 1350.</a>
101	The following materials from the Company's Form 10-Q Report for the quarterly period ended September 30, 2018, formatted in XBRL: (1) Consolidated Balance Sheets, (2) Consolidated Statements of Income, (3) Consolidated Statements of Comprehensive Income, (4) Consolidated Statements of Changes in Shareholders' Equity, (5) Consolidated Statements of Cash Flows and (6) the Notes to Consolidated Financial Statements.



## SIGNATURES

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

FAUQUIER BANKSHARES, INC.  
(Registrant)

By: /s/ Marc J. Bogan  
Marc J. Bogan  
President & Chief Executive Officer  
(Principal Executive Officer)  
Dated: November 9, 2018

By: /s/ Christine E. Headly  
Christine E. Headly  
Executive Vice President & Chief Financial Officer  
(Principal Financial and Accounting Officer)  
Dated: November 9, 2018

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## Section 2: EX-31.1 (EX-31.1)

### Exhibit 31.1

I, Marc J. Bogan, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Fauquier Bankshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)), for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 9, 2018

/s/ Marc J. Bogan

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## Section 3: EX-31.2 (EX-31.2)

Exhibit 31.2

I, Christine E. Headly, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Fauquier Bankshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)), for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 9, 2018

/s/ Christine E. Headly

Christine E. Headly

Executive Vice President & Chief Financial Officer

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## Section 4: EX-32.1 (EX-32.1)

Exhibit 32.1

### CERTIFICATION OF CHIEF EXECUTIVE OFFICER

Pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) I, Marc J. Bogan, as the President and Chief Executive Officer of Fauquier Bankshares, Inc., certify that, to the best of my knowledge and belief, the Quarterly Report on Form 10-Q for the period ended September 30, 2018, which accompanies this certification fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of Fauquier Bankshares, Inc. at the dates and for the periods indicated. The foregoing certification is made pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) and shall not be relied upon for any other purpose. The undersigned expressly disclaims any obligation to update the foregoing certification except as required by law.

Dated: November 9, 2018

/s/ Marc J. Bogan  
Marc J. Bogan  
President & Chief Executive Officer

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## **Section 5: EX-32.2 (EX-32.2)**

**Exhibit 32.2**

### CERTIFICATION OF CHIEF FINANCIAL OFFICER

Pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) I, Christine E. Headly, as Executive Vice President and Chief Financial Officer of Fauquier Bankshares, Inc., certify that, to the best of my knowledge and belief, the Quarterly Report on Form 10-Q for the period ended September 30, 2018, which accompanies this certification fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of Fauquier Bankshares, Inc. at the dates and for the periods indicated. The foregoing certification is made pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) and shall not be relied upon for any other purpose. The undersigned expressly disclaims any obligation to update the foregoing certification except as required by law.

Dated: November 9, 2018

/s/ Christine E. Headly  
Christine E. Headly  
Executive Vice President & Chief Financial Officer

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