

EAGLE FINANCIAL SERVICES INC  
Form 10-K  
March 26, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K  
(Mark One)

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

For the fiscal year ended December 31, 2013

Commission File Number: 0-20146

EAGLE FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Virginia 54-1601306  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

2 East Main Street  
P.O. Box 391 22611  
Berryville, Virginia  
(Address of principal executive offices) (Zip Code)

(540) 955-2510  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, Par Value \$2.50

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

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

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

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

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

The aggregate market value of the voting common equity held by non-affiliates of the registrant at June 30, 2013 was \$62,725,310.

The number of shares of the registrant's Common Stock (\$2.50 par value) outstanding as of February 27, 2014 was 3,417,832.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement for the 2014 Annual Meeting of Shareholders are incorporated by reference into Part III.

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## PART I

### Item 1. Business

#### General

Eagle Financial Services, Inc. (the “Company”) is a bank holding company that was incorporated in 1991. The company is headquartered in Berryville, Virginia and conducts its operations through its subsidiary, Bank of Clarke County (the “Bank”). The Bank is chartered under Virginia law.

The Bank has twelve full-service branches and one drive-through only facility. The Bank’s main office is located at 2 East Main Street in Berryville, Virginia. The Bank opened for business on April 1, 1881. The Bank has offices located in Clarke County, Frederick County, Loudoun County and the City of Winchester. This market area is located in northwestern Virginia.

The Bank offers a wide range of retail and commercial banking services, including demand, savings and time deposits and consumer, mortgage and commercial loans. Branded credit cards are offered through a larger financial institution and the Bank also has a merchant services program which allows its commercial customers to accept credit card payments. The Bank has sixteen ATM locations in its trade area and issues both ATM cards and Debit cards to deposit customers. These cards can be used to withdraw cash at most ATM’s through the Bank’s membership in both regional and national networks. These cards can also be used to make purchases at retailers who accept transactions through the same regional and national networks. The Bank offers telephone banking, internet banking, and mobile banking to its customers. Internet banking also offers online bill payment to consumer and commercial customers. The Bank offers other commercial deposit account services such as ACH origination and remote deposit capture.

Eagle Investment Group (“EIG”) offers both a trust department and investment services. The trust services division of EIG offers a full range of personal and retirement plan services, which include serving as agent for bill paying and custody of assets, as investment manager with full authority or advisor, as trustee or co-trustee for trusts under will or under agreement, as trustee of life insurance trusts, as guardian or committee, as agent under a power of attorney, as executor or co-executor for estates, as custodian or investment advisor for individual retirement plans, and as trustee or trust advisor for corporate retirement plans such as profit sharing and 401(k) plans. The brokerage division of EIG offers a full range of investment services, which include tax-deferred annuities, IRAs and rollovers, mutual funds, retirement plans, 529 college savings plans, life insurance, long term care insurance, fixed income investing, brokerage CDs, and full service or discount brokerage services. Non-deposit investment products are offered through a third party provider.

In addition to the Bank, the Company has a wholly owned subsidiary, Eagle Financial Statutory Trust II, which was formed in connection with the issuance of \$7,000,000 in trust preferred securities in 2007. The Company is also a general partner in a low income housing project. The Company’s subsidiary, Bank of Clarke County, is a partner in Bankers Title Shenandoah, LLC, which sells title insurance, is an investor in Virginia Bankers Insurance Center, LLC, which serves as the broker for insurance sales through its member banks, and is an investor in State Theatre Owner, LLC which rehabilitated the State Theatre of Culpeper, Virginia.

#### Employees

The Company, including the Bank, had 52 officers, 106 other full-time and 25 part-time employees (or 167 full-time equivalent employees) at December 31, 2013. None of the Company’s employees are represented by a union or covered under a collective bargaining agreement. The Company considers relations with its employees to be excellent.

#### Securities and Exchange Commission Filings

The Company maintains an internet website at [www.bankofclarke.com](http://www.bankofclarke.com). Shareholders of the Company and the public may access, free of charge, the Company’s periodic and current reports (including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and any amendments to those reports) filed with or furnished to the Securities and Exchange Commission, through the “Investor Relations” section of the Company’s website. The reports are made available on this website as soon as practicable following the filing of the reports with the SEC. The information is free of charge and may be reviewed, downloaded and printed from the website at any time.



### Competition

There is significant competition for both loans and deposits within the Company's trade area. Competition for loans comes from other commercial banks, savings banks, credit unions, mortgage brokers, finance companies, insurance companies, and other institutional lenders. Competition for deposits comes from other commercial banks, savings banks, credit unions, brokerage firms, and other financial institutions. Based on total deposits at June 30, 2013 as reported to the FDIC, the Company has 6.6% of the total deposits in its market area. The Company's market area includes Clarke County, Frederick County, Loudoun County and the City of Winchester.

### Supervision and Regulation

**General.** As a bank holding company, the Company is subject to regulation under the Bank Holding Company Act of 1956, as amended, and the examination and reporting requirements of the Board of Governors of the Federal Reserve System. As a state-chartered commercial bank, the Bank is subject to regulation, supervision and examination by the Virginia State Corporation Commission's Bureau of Financial Institutions. It is also subject to regulation, supervision and examination by the Federal Reserve Board. Other federal and state laws, including various consumer and compliance laws, govern the activities of the Bank, the investments that it makes and the aggregate amount of loans that it may grant to one borrower.

The following sections summarize the significant federal and state laws applicable to the Company and its subsidiaries. To the extent that statutory or regulatory provisions are described, the description is qualified in its entirety by reference to that particular statutory or regulatory provision.

**The Bank Holding Company Act.** Under the Bank Holding Company Act, the Company is subject to periodic examination by the Federal Reserve and is required to file periodic reports regarding its operations and any additional information that the Federal Reserve may require. Activities at the bank holding company level are limited to the following:

- banking, managing or controlling banks;
- furnishing services to or performing services for its subsidiaries; and
- engaging in other activities that the Federal Reserve has determined by regulation or order to be so closely related to banking as to be a proper incident to these activities.

Some of the activities that the Federal Reserve Board has determined by regulation to be closely related to the business of a bank holding company include making or servicing loans and specific types of leases, performing specific data processing services and acting in some circumstances as a fiduciary or investment or financial adviser. With some limited exceptions, the Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve before:

- acquiring substantially all the assets of any bank;
- acquiring direct or indirect ownership or control of any voting shares of any bank if after such acquisition it would own or control more than 5% of the voting shares of such bank (unless it already owns or controls the majority of such shares); or
- merging or consolidating with another bank holding company.

In addition, and subject to some exceptions, the Bank Holding Company Act and the Change in Bank Control Act, together with their regulations, require Federal Reserve approval prior to any person or company acquiring 25% or more of any class of voting securities of the bank holding company. Prior notice to the Federal Reserve is required if a person acquires 10% or more, but less than 25%, of any class of voting securities of a bank or bank holding company and either has registered securities under Section 12 of the Securities Exchange Act of 1934 or no other person owns a greater percentage of that class of voting securities immediately after the transaction.

In November 1999, Congress enacted the Gramm-Leach-Bliley Act ("GLBA"), which made substantial revisions to the statutory restrictions separating banking activities from other financial activities. Under the GLBA, bank holding companies that are well-capitalized and well-managed and meet other conditions can elect to become "financial holding companies." As financial holding companies, they and their subsidiaries are permitted to acquire or engage in previously impermissible activities such as insurance underwriting, securities underwriting and distribution, travel agency activities, insurance agency activities, merchant banking and other activities that the Federal Reserve

determines to be financial in nature or complementary to these activities. Financial holding companies continue to be subject to the overall oversight and supervision of the Federal Reserve, but the GLBA applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. Although the Company has not elected to become a financial holding company in order to exercise the broader activity powers provided by the GLBA, the Company may elect to do so in the future.

Payment of Dividends. The Company is a legal entity separate and distinct from the Bank. The majority of the Company's revenues are from dividends paid to the Company by the Bank. The Bank is subject to laws and regulations that limit the amount of dividends it can pay. In addition, both the Company and the Bank are subject to various regulatory restrictions relating to the payment of dividends, including requirements to maintain capital at or above regulatory minimums. Banking regulators have indicated that banking organizations should generally pay dividends only if the organization's current earnings are sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition. The Company does not expect that any of these laws, regulations or policies will materially affect the Bank's ability to pay dividends to the Company. Refer to Item 5 for additional information on dividend restrictions. During the year ended December 31, 2013, the Bank paid no dividends to the Company. The Company paid cash dividends of \$1.9 million to shareholders during 2013.

The FDIC has the general authority to limit the dividends paid by insured banks if the payment is deemed an unsafe and unsound practice. The FDIC has indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsound and unsafe banking practice.

Insurance of Accounts, Assessments and Regulation by the FDIC. The Bank's deposits are insured up to applicable limits by the FDIC. In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act permanently raised the standard maximum deposit insurance amount to \$250,000. The FDIC has implemented a risk-based assessment system in which insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors. Effective April 1, 2011, the assessment base is an institution's average consolidated total assets less average tangible equity, and the initial base assessment rates are between 5 and 35 basis points depending on the institutions risk category, and subject to potential adjustment based on certain long-term unsecured debt and brokered deposits held by the institution.

Capital Requirements. The Federal Reserve Board has issued risk-based and leverage capital guidelines applicable to banking organizations that it supervises. Under the risk-based capital requirements, the Company and the Bank are each generally required to maintain a minimum ratio of total capital to risk-weighted assets of 8%. At least half of the total capital must be composed of "Tier 1 Capital", which is defined as common equity, retained earnings and qualifying perpetual preferred stock, less certain intangibles. The remainder may consist of "Tier 2 Capital", which is defined as specific subordinated debt, some hybrid capital instruments and other qualifying preferred stock and a limited amount of the loan loss allowance. In addition, each of the federal banking regulatory agencies has established minimum leverage capital requirements for banking organizations. Under these requirements, banking organizations must maintain a minimum ratio of Tier 1 capital to adjusted average quarterly assets equal to 3% to 5%, subject to federal bank regulatory evaluation of an organization's overall safety and soundness. In sum, the capital measures used by the federal banking regulators are as follows:

- the Total Capital ratio, which is the total of Tier 1 Capital and Tier 2 Capital;
- the Tier 1 Capital ratio; and
- the leverage ratio.

Under these regulations, a bank will be classified as follows:

• "well capitalized" if it has a Total Capital ratio of 10% or greater, a Tier 1 Capital ratio of 6% or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure;

• "adequately capitalized" if it has a Total Capital ratio of 8% or greater, a Tier 1 Capital ratio of 4% or greater, and a leverage ratio of 4% or greater – or 3% in certain circumstances – and is not well capitalized;

• "undercapitalized" if it has a Total Capital ratio of less than 8%, a Tier 1 Capital ratio of less than 4%—or 3% in certain circumstances;

• "significantly undercapitalized" if it has a Total Capital ratio of less than 6%, a Tier 1 Capital ratio of less than 3%, or a leverage ratio of less than 3%; or

• "critically undercapitalized" if its tangible equity is equal to or less than 2% of average quarterly tangible assets.





The risk-based capital standards of the Federal Reserve Board explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution's overall capital adequacy. The capital guidelines also provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a banking organization's capital adequacy.

The Dodd-Frank Act contains a number of provisions dealing with capital adequacy of insured depository institutions and their holding companies, which may result in more stringent capital requirements. Under the Collins Amendment to the Dodd-Frank Act, federal regulators have been directed to establish minimum leverage and risk-based capital requirements for, among other entities, banks and bank holding companies on a consolidated basis. These minimum requirements can't be less than the generally applicable leverage and risk-based capital requirements established for insured depository institutions nor quantitatively lower than the leverage and risk-based capital requirements established for insured depository institutions that were in effect as of July 21, 2010. These requirements in effect create capital level floors for bank holding companies similar to those in place currently for insured depository institutions. The Collins Amendment also excludes trust preferred securities issued after May 19, 2010 from being included in Tier 1 capital unless the issuing company is a bank holding company with less than \$500 million in total assets. Trust preferred securities issued prior to that date will continue to count as Tier 1 capital for bank holding companies with less than \$15 billion in total assets, and such securities will be phased out of Tier 1 capital treatment for bank holding companies with over \$15 billion in total assets over a three-year period beginning in 2013.

Accordingly, the Company's trust preferred securities will continue to qualify as Tier 1 capital.

The FDIC may take various corrective actions against any undercapitalized bank and any bank that fails to submit an acceptable capital restoration plan or fails to implement a plan acceptable to the FDIC. These powers include, but are not limited to, requiring the institution to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions by any bank holding company that controls the institution, requiring divestiture by the institution of its subsidiaries or by the holding company of the institution itself, requiring new election of directors, and requiring the dismissal of directors and officers. The Bank presently maintains sufficient capital to remain well capitalized under these guidelines.

In 2013, the Federal Reserve, the FDIC and the OCC approved a new rule that will substantially amend the regulatory risk-based capital rules applicable to us. The final rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. The final rule includes new minimum risk-based capital and leverage ratios which will be effective for us on January 1, 2015, and refines the definition of what constitutes "capital" for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 ("CET1") capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6%, which is increased from 4%; (iii) a total capital ratio of 8%, which is unchanged from the current rules; and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a "capital conservation buffer" of 2.5% above the new regulatory minimum capital ratios, and when fully effective in 2019, will result in the following minimum ratios: (a) a common equity Tier 1 capital ratio of 7.0%; (b) a Tier 1 to risk-based assets capital ratio of 8.5%; and (c) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such activities.

In addition, the Basel III capital rules provide for a number of new deductions from and adjustments to capital and prescribe a standardized approach for risk weightings that expand the risk-weighting categories from the current four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories.



Other Safety and Soundness Regulations. There are a number of obligations and restrictions imposed on bank holding companies and their depository institution subsidiaries by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insurance funds in the event that the depository institution is insolvent or is in danger of becoming insolvent. For example, under the requirements of the Federal Reserve Board with respect to bank holding company operations, a bank holding company is required to serve as a source of financial strength to its subsidiary depository institutions and to commit resources to support such institutions in circumstances where it might not do so otherwise. In addition, the “cross-guarantee” provisions of federal law require insured depository institutions under common control to reimburse the FDIC for any loss suffered or reasonably anticipated by the FDIC as a result of the insolvency of commonly controlled insured depository institutions or for any assistance provided by the FDIC to commonly controlled insured depository institutions in danger of failure. The FDIC may decline to enforce the cross-guarantee provision if it determines that a waiver is in the best interests of the deposit insurance funds. The FDIC’s claim for reimbursement under the cross guarantee provisions is superior to claims of shareholders of the insured depository institution or its holding company but is subordinate to claims of depositors, secured creditors and nonaffiliated holders of subordinated debt of the commonly controlled insured depository institutions.

Interstate Banking and Branching. Current federal law authorizes interstate acquisitions of banks and bank holding companies without geographic limitation. Effective June 1, 1997, a bank headquartered in one state is authorized to merge with a bank headquartered in another state, as long as neither of the states had opted out of such interstate merger authority prior to such date. After a bank has established branches in a state through an interstate merger transaction, the bank may establish and acquire additional branches at any location in the state where a bank headquartered in that state could have established or acquired branches under applicable federal or state law.

Monetary Policy. The commercial banking business is affected not only by general economic conditions but also by the monetary policies of the Federal Reserve Board. The instruments of monetary policy employed by the Federal Reserve Board include open market operations in United States government securities, changes in the discount rate on member bank borrowing and changes in reserve requirements against deposits held by all federally insured banks. The Federal Reserve Board’s monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. In view of changing conditions in the national and international economy and in the money markets, as well as the effect of actions by monetary fiscal authorities, including the Federal Reserve Board, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or the business and earnings of the Bank.

Federal Reserve System. In 1980, Congress enacted legislation that imposed reserve requirements on all depository institutions that maintain transaction accounts or nonpersonal time deposits. NOW accounts, money market deposit accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to these reserve requirements, as are any nonpersonal time deposits at an institution.

The reserve percentages are subject to adjustment by the Federal Reserve Board. Because required reserves must be maintained in the form of vault cash or in a non-interest-bearing account at, or on behalf of, a Federal Reserve Bank, the effect of the reserve requirement is to reduce the amount of the institution’s interest-earning assets.

Transactions with Affiliates. Transactions between banks and their affiliates are governed by Sections 23A and 23B of the Federal Reserve Act. An affiliate of a bank is any bank or entity that controls, is controlled by or is under common control with such bank. Generally, Sections 23A and 23B (i) limit the extent to which the Bank or its subsidiaries may engage in “covered transactions” with any one affiliate to an amount equal to 10% of such institution’s capital stock and surplus, and maintain an aggregate limit on all such transactions with affiliates to an amount equal to 20% of such capital stock and surplus, and (ii) require that all such transactions be on terms substantially the same, or at least as favorable, to the association or subsidiary as those provided to a nonaffiliate. The term “covered transaction” includes the making of loans, purchase of assets, issuance of a guarantee and similar other types of transactions.

**Transactions with Insiders.** The Federal Reserve Act and related regulations impose specific restrictions on loans to directors, executive officers and principal shareholders of banks. Under Section 22(h) of the Federal Reserve Act, loans to a director, an executive officer and to a principal shareholder of a bank, and some affiliated entities of any of the foregoing, may not exceed, together with all other outstanding loans to such person and affiliated entities, the bank's loan-to-one borrower limit. Loans in the aggregate to insiders and their related interests as a class may not exceed two times the bank's unimpaired capital and unimpaired surplus until the bank's total assets equal or exceed \$100,000,000, at which time the aggregate is limited to the bank's unimpaired capital and unimpaired surplus. Section 22(h) also prohibits loans, above amounts prescribed by the appropriate federal banking agency, to directors, executive officers and principal shareholders of a bank or bank holding company, and their respective affiliates, unless such loan is approved in advance by a majority of the board of directors of the bank with any "interested" director not participating in the voting. The FDIC has prescribed the loan amount, which includes all other outstanding loans to such person, as to which such prior board of director approval is required, as being the greater of \$25,000 or 5% of capital and surplus (up to \$500,000). Section 22(h) requires that loans to directors, executive officers and principal shareholders be made on terms and underwriting standards substantially the same as offered in comparable transactions to other persons.

The Dodd-Frank Act also provides that banks may not "purchase an asset from, or sell an asset to" a bank insider (or their related interests) unless (i) the transaction is conducted on market terms between the parties, and (ii) if the proposed transaction represents more than 10 percent of the capital stock and surplus of the bank, it has been approved in advance by a majority of the bank's non-interested directors.

**Community Reinvestment Act.** Under the Community Reinvestment Act and related regulations, depository institutions have an affirmative obligation to assist in meeting the credit needs of their market areas, including low and moderate-income areas, consistent with safe and sound banking practice. The Community Reinvestment Act directs each bank to maintain a public file containing specific information, including all written comments received from the public for the current year and each of the previous two calendar years that specifically relate to the bank's performance in helping to meet community credit needs. Depository institutions are periodically examined for compliance with the Community Reinvestment Act and are periodically assigned ratings in this regard. Banking regulators consider a depository institution's Community Reinvestment Act rating when reviewing applications to establish new branches, undertake new lines of business, and/or acquire part or all of another depository institution. An unsatisfactory rating can significantly delay or even prohibit regulatory approval of a proposed transaction by a bank holding company or its depository institution subsidiaries.

The GLBA and federal bank regulators have made various changes to the Community Reinvestment Act. Among other changes, Community Reinvestment Act agreements with private parties must be disclosed and annual reports must be made to a bank's primary federal regulator. A bank holding company will not be permitted to become a financial holding company and no new activities authorized under the GLBA may be commenced by a holding company or by a bank financial subsidiary if any of its bank subsidiaries received less than a "satisfactory" rating in its latest Community Reinvestment Act examination.

**Fair Lending; Consumer Laws.** In addition to the Community Reinvestment Act, other federal and state laws regulate various lending and consumer aspects of the banking business. Governmental agencies, including the Department of Housing and Urban Development, the Federal Trade Commission and the Department of Justice, have become concerned that prospective borrowers experience discrimination in their efforts to obtain loans from depository and other lending institutions. These agencies have brought litigation against depository institutions alleging discrimination against borrowers. Many of these suits have been settled, in some cases for material sums, short of a full trial.

These governmental agencies have clarified what they consider to be lending discrimination and have specified various factors that they will use to determine the existence of lending discrimination under the Equal Credit Opportunity Act and the Fair Housing Act, including evidence that a lender discriminated on a prohibited basis, evidence that a lender treated applicants differently based on prohibited factors in the absence of evidence that the treatment was the result of prejudice or a conscious intention to discriminate, and evidence that a lender applied an

otherwise neutral non-discriminatory policy uniformly to all applicants, but the practice had a discriminatory effect, unless the practice could be justified as a business necessity.

Banks and other depository institutions are also subject to numerous consumer-oriented laws and regulations. These laws, which include the Truth in Lending Act, the Truth in Savings Act, the Real Estate Settlement Procedures Act, the Electronic Funds Transfer Act, the Equal Credit Opportunity Act, and the Fair Housing Act, require compliance by depository institutions with various disclosure requirements and requirements regulating the availability of funds after deposit or the making of some loans to customers.

Gramm-Leach-Bliley Act of 1999. The Gramm-Leach-Bliley Act of 1999 was signed into law on November 12, 1999. The GLBA covers a broad range of issues, including a repeal of most of the restrictions on affiliations among depository institutions, securities firms and insurance companies. The following description summarizes some of its significant provisions.

The GLBA repeals sections 20 and 32 of the Glass-Steagall Act, thus permitting unrestricted affiliations between banks and securities firms. It also permits bank holding companies to elect to become financial holding companies. A financial holding company may engage in or acquire companies that engage in a broad range of financial services, including securities activities such as underwriting, dealing, investment, merchant banking, insurance underwriting, sales and brokerage activities. In order to become a financial holding company, the bank holding company and all of its affiliated depository institutions must be well-capitalized, well-managed and have at least a satisfactory Community Reinvestment Act rating.

The GLBA provides that the states continue to have the authority to regulate insurance activities, but prohibits the states in most instances from preventing or significantly interfering with the ability of a bank, directly or through an affiliate, to engage in insurance sales, solicitations or cross-marketing activities. Although the states generally must regulate bank insurance activities in a nondiscriminatory manner, the states may continue to adopt and enforce rules that specifically regulate bank insurance activities in specific areas identified under the law. Under the new law, the federal bank regulatory agencies adopted insurance consumer protection regulations that apply to sales practices, solicitations, advertising and disclosures.

The GLBA adopts a system of functional regulation under which the Federal Reserve Board is designated as the umbrella regulator for financial holding companies, but financial holding company affiliates are principally regulated by functional regulators such as the FDIC for state nonmember bank affiliates, the Securities and Exchange Commission for securities affiliates, and state insurance regulators for insurance affiliates. It repeals the broad exemption of banks from the definitions of “broker” and “dealer” for purposes of the Securities Exchange Act of 1934, as amended. It also identifies a set of specific activities, including traditional bank trust and fiduciary activities, in which a bank may engage without being deemed a “broker,” and a set of activities in which a bank may engage without being deemed a “dealer.” Additionally, the new law makes conforming changes in the definitions of “broker” and “dealer” for purposes of the Investment Company Act of 1940, as amended, and the Investment Advisers Act of 1940, as amended.

The GLBA contains extensive customer privacy protection provisions. Under these provisions, a financial institution must provide to its customers, both at the inception of the customer relationship and on an annual basis, the institution’s policies and procedures regarding the handling of customers’ nonpublic personal financial information. The new law provides that, except for specific limited exceptions, an institution may not provide such personal information to unaffiliated third parties unless the institution discloses to the customer that such information may be so provided and the customer is given the opportunity to opt out of such disclosure. An institution may not disclose to a non-affiliated third party, other than to a consumer reporting agency, customer account numbers or other similar account identifiers for marketing purposes. The GLBA also provides that the states may adopt customer privacy protections that are more strict than those contained in the act.

Bank Secrecy Act. Under the Bank Secrecy Act (“BSA”), a financial institution is required to have systems in place to detect certain transactions, based on the size and nature of the transaction. Financial institutions are generally required to report cash transactions involving more than \$10,000 to the United States Treasury. In addition, financial institutions are required to file suspicious activity reports for transactions that involve more than \$5,000 and which the financial institution knows, suspects or has reason to suspect, involves illegal funds, is designed to evade the requirements of the BSA or has no lawful purpose. The USA PATRIOT Act, enacted in response to the September 11, 2001 terrorist attacks, requires bank regulators to consider a financial institution’s compliance with the BSA when reviewing applications from a financial institution. As part of its BSA program, the USA PATRIOT Act also requires a financial institution to follow recently implemented customer identification procedures when opening accounts for new customers and to review lists of individuals and entities who are prohibited from opening accounts at financial institutions.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The Sarbanes-Oxley Act is applicable to all companies with equity securities registered or that file reports under the Securities Exchange Act of 1934. In particular, the Sarbanes-Oxley Act establishes: (i) new requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) new standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for the reporting company and its directors and executive officers; and (v) new and increased civil and criminal penalties for violations of the securities laws. Many of the provisions were effective immediately while other provisions become effective over a period of time and are subject to rulemaking by the SEC. Because the Company's common stock is registered with the SEC, it is currently subject to this Act.



Future Regulatory Uncertainty. Because federal and state regulation of financial institutions changes regularly and is the subject of constant legislative debate, the Company cannot forecast how federal and state regulation of financial institutions may change in the future and, as a result, impact our operations. The Company fully expects that the financial institution industry will remain heavily regulated in the near future and that additional laws or regulations may be adopted further regulating specific banking practices.

Incentive Compensation. In June 2010, the Federal Reserve issued a final rule on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. Banking organizations are instructed to review their incentive compensation policies to ensure that they do not encourage excessive risk-taking and implement corrective programs as needed. The Federal Reserve Board will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Bank, that are not “large, complex banking organizations.” These reviews will be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization’s supervisory ratings, which can affect the organization’s ability to make acquisitions and take other actions.

Dodd-Frank Act. In July 2010, the Dodd-Frank Act was signed into law, incorporating numerous financial institution regulatory reforms. Some of these reforms have been implemented. Of the 400 rules enacted in Dodd-Frank, only 51 had been completed as of mid-July 2013, according to a Dodd-Frank progress report issued in July 2013 from the law firm of Davis Polk & Wardell LLP. The Dodd-Frank Act implements far-reaching reforms of major elements of the financial landscape, particularly for larger financial institutions. Many of its provisions do not directly impact community-based institutions like the Bank. For instance, provisions that regulate derivative transactions and limit derivatives trading activity of federally-insured institutions, enhance supervision of “systemically significant” institutions, impose new regulatory authority over hedge funds, limit proprietary trading by banks, and phase-out the eligibility of trust preferred securities for Tier 1 capital are among the provisions that do not directly impact the Bank either because of exemptions for institutions below a certain asset size or because of the nature of the Bank’s operations. Provisions that could impact the Bank include the following:

FDIC Assessments. The Dodd-Frank Act changes the assessment base for federal deposit insurance from the amount of insured deposits to average consolidated total assets less its average tangible equity. In addition, it increases the minimum size of the Deposit Insurance Fund (“DIF”) and eliminates its ceiling, with the burden of the increase in the minimum size on institutions with more than \$10 billion in assets.

Deposit Insurance. As scheduled, the unlimited insurance for noninterest bearing transaction accounts provided under the Dodd-Frank Wall Street Reform and Consumer Protection Act expired on December 31, 2012. Deposits held in noninterest bearing transaction accounts are now aggregated with any interest bearing deposits the owner may hold in the same ownership category, and the combined total is insured up to at least \$250,000.

Interest on Demand Deposits. The Dodd-Frank Act also provides that, effective one year after the date of enactment, depository institutions may pay interest on demand deposits, including business transaction and other accounts.

Interchange Fees. The Federal Reserve set a cap on debit card interchange fees charged to retailers. While banks with less than \$10 billion in assets, such as the Bank, are exempted from this measure, it is likely that all banks could be forced by market pressures to lower their interchange fees or face potential rejection of their cards by retailers.

Consumer Financial Protection Bureau. The Dodd-Frank Act centralizes responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau, responsible for implementing federal consumer protection laws, although banks below \$10 billion in assets will continue to be examined and supervised for compliance with these laws by their federal bank regulator.

Mortgage Lending. New requirements are imposed on mortgage lending, including new minimum underwriting standards, restrictions concerning loan originator compensation, qualifications of, and registration or licensing of loan originators, special consumer protections for mortgage loans that do not meet certain provision qualifications,

prohibitions and limitations on certain mortgage terms and various new mandated disclosures to mortgage borrowers.  
Holding Company Capital Levels. Bank regulators are required to establish minimum capital levels for holding companies that are at least as stringent as those currently applicable to banks. In addition, all trust preferred securities issued after May 19, 2010 will be counted as Tier 2 capital, but the Company's currently outstanding trust preferred securities will continue to qualify as Tier 1 capital.

De Novo Interstate Branching. National and state banks are permitted to establish de novo interstate branches outside of their home state, and bank holding companies and banks must be well-capitalized and well managed in order to acquire banks located outside their home state.

Transactions with Affiliates. The Dodd-Frank Act enhances the requirements for certain transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including an expansion of the definition of “covered transactions” and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained.

Transactions with Insiders. Insider transaction limitations are expanded through the strengthening of loan restrictions to insiders and the expansion of the types of transactions subject to the various limits, including derivative transactions, repurchase agreements, reverse repurchase agreements and securities lending or borrowing transactions. Restrictions are also placed on certain asset sales to and from an insider to an institution, including requirements that such sales be on market terms and, in certain circumstances, approved by the institution’s board of directors.

Corporate Governance. The Dodd-Frank Act includes corporate governance revisions that apply to all public companies, not just financial institutions, including with regard to executive compensation and proxy access to shareholders.

Many aspects of the Dodd-Frank Act are subject to rulemaking and interpretation and will take effect over several years, and their impact on the Company or the financial industry is difficult to predict before such regulations are adopted.

Volcker Rule. The Dodd-Frank Act prohibits insured depository institutions and their holding companies from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of 3% of Tier 1 capital in private equity and hedge funds (known as the “Volcker Rule”). On December 10, 2013, the federal bank regulatory agencies adopted final rules implementing the Volcker Rule. These final rules prohibit banking entities from (i) engaging in short-term proprietary trading for their own accounts, and (ii) having certain ownership interests in and relationships with hedge funds or private equity funds. The final rules are intended to provide greater clarity with respect to both the extent of those primary prohibitions and of the related exemptions and exclusions. The final rules also require each regulated entity to establish an internal compliance program that is consistent with the extent to which it engages in activities covered by the Volcker Rule, which must include (for the largest entities) making regular reports about those activities to regulators. Although the final rules provide some tiering of compliance and reporting obligations based on size, the fundamental prohibitions of the Volcker Rule apply to banking entities of any size, including the Company and the Subsidiary Banks. The final rules are effective April 1, 2014, but the conformance period has been extended from its statutory end date of July 21, 2014 until July 21, 2015. The Company has evaluated the implications of the final rules on its investments and does not expect any material financial implications.

Under the final rules implementing the Volcker Rule, banking entities would have been prohibited from owning certain collateralized debt obligations (“CDOs”) backed by trust preferred securities (“TruPS”) as of July 21, 2015, which could have forced banking entities to recognize unrealized market losses based on the inability to hold any such investments to maturity. However, on January 14, 2014, the federal bank regulatory agencies issued an interim rule, effective April 1, 2014, exempting TruPS CDOs from the Volcker Rule if (i) the CDO was established prior to May 19, 2010, (ii) the banking entity reasonably believes that the offering proceeds of the CDO were used to invest primarily in TruPS issued by banks with less than \$15 billion in assets, and (iii) the banking entity acquired the CDO on or before December 10, 2013. However, regulators are soliciting comments to the Interim Rule, and this exemption could change prior to its effective date. The Company currently does not have any impermissible holdings of TruPS CDOs under the interim rule, and therefore, will not be required to divest of any such investments or change the accounting treatment.

Ability-to-Repay and Qualified Mortgage Rule. Pursuant to the Dodd-Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring creditors to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Creditors are required to determine consumers’ ability to repay in one of two ways. The first alternative requires the creditor to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related

obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the creditor can originate “qualified mortgages,” which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a “qualified mortgage” is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are “higher-priced” (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not “higher-priced” (e.g. prime loans) are given a safe harbor of compliance. To meet the mortgage credit needs of a broader customer base, the Company is predominantly an originator of mortgages that are in compliance with the Ability-to-Pay rules.

#### Item 1A. Risk Factors

The Company is subject to many risks that could adversely affect its future financial condition and performance and, therefore, the market value of its securities. The risk factors applicable to the Company include, but are not limited to the following:

Government measures to regulate the financial industry, including the Dodd-Frank Act, subject us to increased regulation and could adversely affect us.

As a financial institution, we are heavily regulated at the state and federal levels. As a result of the financial crisis and related global economic downturn that began in 2007, we have faced, and expect to continue to face, increased public and legislative scrutiny as well as stricter and more comprehensive regulation of our financial services practices. In July 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act includes significant changes in the financial regulatory landscape and will impact all financial institutions, including the Company and the Bank. Many of the provisions of the Dodd-Frank Act have begun to be or will be implemented over the next several years and will be subject both to further rulemaking and the discretion of applicable regulatory bodies. Because the ultimate impact of the Dodd-Frank Act will depend on future regulatory rulemaking and interpretation, we cannot predict the full effect of this legislation on our businesses, financial condition or results of operations. Among other things, the Dodd-Frank Act and the regulations implemented thereunder could limit debit card interchange fees, increase FDIC assessments, impose new requirements on mortgage lending, and establish more stringent capital requirements on bank holding companies. As a result of these and other provisions in the Dodd-Frank Act, we could experience additional costs, as well as limitations on the products and services we offer and on our ability to efficiently pursue business opportunities, which may adversely affect our businesses, financial condition or results of operations. In addition, implementation of the BASEL III requirements could increase required capital minimums as well as compliance costs due to their complexity.

The Company's success depends upon its ability to manage interest rate risk.

The profitability of the Company depends significantly on its net interest income, which is the difference between the interest earned on loans, securities and other interest-earning assets, and the interest paid on deposits and borrowings. Changes in interest rates will affect the rates earned on securities and loans and rates paid on deposits and other borrowings. While the Company believes that its current interest rate exposure does not present any significant negative exposure to interest rate changes, it cannot eliminate its exposure to interest rate risk because the factors which cause interest rate risk are beyond the Company's control. These factors include competition, federal economic, monetary and fiscal policies, and general economic conditions.

The Company's success depends upon its ability to compete effectively in the banking industry.

The Company's banking subsidiary faces competition from banks and other financial institutions, including savings and loan associations, savings banks, finance companies and credit unions for deposits, loans and other financial services in our market area. Certain divisions within the banking subsidiary face competition from wealth management and investment brokerage firms. A number of these banks and other financial institutions are significantly larger and have substantially greater access to capital and other resources, as well as larger lending limits and branch systems, and offer a wider array of banking services. This competition may reduce or limit our margins and our market share and may adversely affect our results of operations and financial condition.

Difficult market conditions have adversely affected our industry.

Dramatic declines in the housing market, falling home prices and increasing foreclosures, and unemployment and under-employment have negatively impacted the credit performance of real estate related loans and resulted in significant write-downs of asset values by financial institutions. These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The

resulting economic pressure on consumers and lack of confidence in the financial markets has adversely affected our business and results of operations. Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for credit losses, although these conditions have shown signs of stabilization in 2012 and 2013. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial institutions industry.

The Company could be adversely affected by economic conditions in its market area.

The Company's branches are located in the counties of Clarke, Frederick and Loudoun, and the City of Winchester. The current recession presents numerous challenges to the way we do business. Poor economic conditions, which are beyond our control, negatively impact the Company's financial condition and performance. These conditions influence the volume of loans and deposits, the asset quality of the loan portfolio, and pricing of loans and deposits.

The Company will be subject to more stringent capital and liquidity requirements as a result of the Basel III regulatory capital reforms and the Dodd-Frank Act, the short-term and long-term impact of which is uncertain.

The Company and the Bank are each subject to capital adequacy guidelines and other regulatory requirements specifying minimum amounts and types of capital which each must maintain. From time to time, regulators implement changes to these regulatory capital adequacy guidelines. Under the Dodd-Frank Act, the federal banking agencies have established stricter capital requirements and leverage limits for banks and bank holding companies that are based on the Basel III regulatory capital reforms. If the Company and the Bank fail to meet these minimum capital guidelines and/or other regulatory requirements, the Company's financial condition would be materially and adversely affected.

New regulations issued by the CFPB could adversely impact the Company's earnings.

The CFPB has broad rulemaking authority to administer and carry out the provisions of the Dodd-Frank Act with respect to financial institutions that offer covered financial products and services to consumers. Pursuant to the Dodd-Frank Act, the CFPB issued a final rule effective January 10, 2014, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms, or to originate "qualified mortgages" that meet specific requirements with respect to terms, pricing and fees. The new rule also contains new disclosure requirements at mortgage loan origination and in monthly statements. These requirements could limit the Company's ability to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could adversely impact the Company's profitability. The Company's concentration in loans secured by real estate may increase its credit losses, which would negatively affect our financial results.

At December 31, 2013, loans secured by real estate totaled \$406.6 million and represented 91.52% of the Company's loan portfolio. If we experience further adverse changes in the local real estate market or in the local or national economy, borrowers' ability to pay these loans may be further impaired, which could impact the Company's financial performance. The Company attempts to limit its exposure to this risk by applying good underwriting practices at origination, evaluating the appraisals used to establish property values, and routinely monitoring the financial condition of borrowers. If the value of real estate serving as collateral for the loan portfolio were to continue to decline materially, a significant part of the loan portfolio could become under-collateralized. If the loans that are secured by real estate become troubled when real estate market conditions are declining or have declined, in the event of foreclosure, the Company may not be able to realize the amount of collateral that was anticipated at the time of originating the loan. In that event, the Company might have to increase the provision for loan losses, which could have a material adverse effect on its operating results and financial condition.

An inadequate allowance for loan losses would reduce our earnings.

Our earnings are significantly affected by our ability to properly originate, underwrite and service loans. We maintain an allowance for loan losses based upon many factors, including the following:

- actual loan loss history;
- volume, growth, and composition of the loan portfolio;
- the amount of non-performing loans and the value of their related collateral;

the effect of changes in the local real estate market on collateral values;  
the effect of current economic conditions on a borrower's ability to pay; and  
other factors deemed relevant by management.



These determinations are based upon estimates that are inherently subjective, and their accuracy depends on the outcome of future events; therefore, realized losses may differ from current estimates. Changes in economic, operating, and other conditions, including changes in interest rates, which are generally beyond our control, could increase actual loan losses significantly. As a result, actual losses could exceed our current allowance estimate. We cannot provide assurance that our allowance for loan losses is sufficient to cover actual loan losses should such losses differ significantly from the current estimates.

In addition, there can be no assurance that our methodology for assessing our asset quality will succeed in properly identifying impaired loans or calculating an appropriate loan loss allowance. We could sustain losses if we incorrectly assess the creditworthiness of our borrowers or fail to detect or respond to deterioration in asset quality in a timely manner. If our assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb losses, or if bank regulatory authorities require us to increase the allowance for loan losses as a part of their examination process, our earnings and capital could be significantly and adversely affected.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

The Company may not be able to successfully manage its growth or implement its growth strategy, which may adversely affect results of operations and financial condition.

A key component of the Company's business strategy is to continue to grow and expand. The Company's ability to grow and expand depends upon its ability to open new branch locations, attract new deposits to the existing and new branch locations, and identify attractive loan and investment opportunities. The Company may not be able to implement its growth strategy if it is unable to identify attractive markets or branch locations. Once identified, successfully managing growth will depend on integrating the new branch locations while maintaining adequate capital, cost controls and asset quality. As this growth strategy is implemented, the Company will incur construction costs and increased personnel, occupancy and other operating expenses. Because these costs are incurred before new deposits and loans are generated, adding new branch locations will initially decrease earnings, despite efficient execution of this strategy.

The Company relies heavily on its senior management team and the unexpected loss of key officers could adversely affect operations.

The Company believes that its growth and success depends heavily upon the skills of its senior management team. The Company also depends on the experience of its subsidiary's officers and on their relationships with the customers they serve. The loss of one or more of these officers could disrupt the Company's operations and impair its ability to implement its business strategy, which could adversely affect the Company's financial condition and performance.

#### Item 1B. Unresolved Staff Comments

None.

#### Item 2. Properties

The Company owns or leases buildings which are used in normal business operations. The Company's corporate headquarters, and that of Bank of Clarke County, is located at 2 East Main Street, Berryville, Virginia, 22611. At December 31, 2013, Bank of Clarke County operated twelve full-service branches and one drive-through only facility in the Virginia communities of Berryville, Winchester, Boyce, Stephens City, Round Hill and Purcellville. See Note 1

“Nature of Banking Activities and Significant Accounting Policies” and Note 6 “Bank Premises and Equipment, Net” in the “Notes to the Consolidated Financial Statements” of this Form 10-K for information with respect to the amounts at which bank premises and equipment are carried and commitments under long-term leases.

All of the Company’s properties are well maintained, are in good operating condition and are adequate for the Company’s present and anticipated future needs.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which the Company is a party or of which the property of the Company is subject.

Item 4. Mine Safety Disclosures

None.

## PART II

## Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company’s common stock is not listed for trading on a registered exchange. Shares of the common stock of the Company are traded on the over-the-counter (OTC) market and quoted on the OTC Bulletin Board under the symbol “EFSI.” The OTC Bulletin Board provides information about the common stock to professional market makers who match sellers with buyers. Securities brokers can obtain information from the OTC Bulletin Board when working with clients. When a client decides to initiate a transaction, the broker will contact one of the stock’s market makers.

The Company has a limited record of trades involving its common stock in the sense of “bid” and “ask” prices or in highs and lows. The effort to accurately disclose trading prices is made more difficult due to the fact that price per share information is not required to be disclosed to the Company when shares of its stock have been sold by holders and purchased by others. The table titled “Common Stock Market Price and Dividend Data” summarizes the high and low sales prices of shares of the Company’s common stock on the basis of trades known to the Company (including trades through the OTC Bulletin Board) and dividends declared during 2013 and 2012. The Company may not be aware of the per share price of all trades made.

## Common Stock Market Price and Dividend Data

	2013		2012		Dividends Per Share	
	High	Low	High	Low	2013	2012
1st Quarter	\$23.50	\$21.40	\$21.00	\$15.50	\$0.19	\$0.18
2nd Quarter	23.35	22.10	22.25	19.35	0.19	0.18
3rd Quarter	24.80	23.35	22.10	18.10	0.19	0.18
4th Quarter	23.95	20.55	23.00	21.05	0.19	0.19

As of February 27, 2014, the Company had approximately 1,120 shareholders of record.

The Company has historically paid dividends on a quarterly basis. The final determination of the timing, amount and payment of dividends on the Common Stock is at the discretion of the Company’s Board of Directors. Some of the factors affecting the payment of dividends on the Company’s common stock are operating results, financial condition, capital adequacy, regulatory requirements and shareholders returns.

The Company is organized under the Virginia Stock Corporation Act, which prohibits the payment of a dividend if, after giving it effect, the corporation would not be able to pay its debts as they become due in the usual course of business or if the corporation’s total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the corporation were to be dissolved, to satisfy the preferential rights upon dissolution of any preferred shareholders.

The Company is a legal entity separate and distinct from its subsidiaries. Its ability to distribute cash dividends will depend primarily on the ability of the Bank to pay dividends to it, and the Bank is subject to laws and regulations that limit the amount of dividends that it can pay. As a state member bank, the Bank is subject to certain restrictions imposed by the reserve and capital requirements of federal and Virginia banking statutes and regulations. Under Virginia law, a bank may not declare a dividend in excess of its undivided profits. Additionally, the Bank may not declare a dividend if the total amount of all dividends, including the proposed dividend, declared by it in any calendar year exceeds the total of its retained net income of that year to date, combined with its retained net income of the two preceding years, unless the dividend is approved by the Federal Reserve.

The Federal Reserve and the state of Virginia have the general authority to limit the dividends paid by insured banks if the payment is deemed an unsafe and unsound practice. Both the state of Virginia and the Federal Reserve have indicated that paying dividends that deplete a bank’s capital base to an inadequate level would be an unsafe and unsafe banking practice. Under the Federal Reserve’s regulations, the Bank may not declare or pay any dividend in

excess of its net income for the current year plus any retained net income from the prior two calendar years. The Bank may also not declare or pay a dividend without the approval of its board and two-thirds of its shareholders if the dividend would exceed its undivided profits, as reported to the Federal Reserve.

In addition, the Company is subject to certain regulatory requirements to maintain capital at or above regulatory minimums. These regulatory requirements regarding capital affect its dividend policies. The Federal Reserve has indicated that a bank holding company should generally pay dividends only if its current earnings are sufficient to fully fund the dividends, and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition.

#### Stock Performance

The following line graph compares the cumulative total return to the shareholders of the Company to the returns of the NASDAQ Bank Index and the NASDAQ Composite Index for the last five years. The amounts in the table represent the value of the investment on December 31<sup>st</sup> of the year indicated, assuming \$100 was initially invested on December 31, 2008 and the reinvestment of dividends. See Management Discussion and Analysis sections Liquidity and Capital Resources and Note 17, "Restrictions on Dividends, Loans and Advances" to the Consolidated Financial Statements for information on Eagle Financial Services, Inc. ability and intent to pay dividends.

	2008	2009	2010	2011	2012	2013
Eagle Financial Services, Inc.	\$ 100	\$ 102	\$ 112	\$ 119	\$ 162	\$ 171
NASDAQ Bank Index	100	81	91	80	92	128
NASDAQ Composite Index	100	144	168	165	191	265

## Item 6. Selected Financial Data

The following table presents selected financial data, which was derived from the Company's audited financial statements for the periods indicated.

	December 31,					
	2013	2012	2011	2010	2009	
	(dollars in thousands, except per share amounts)					
<b>Income Statement Data:</b>						
Interest and dividend income	\$25,036	\$26,566	\$27,571	\$27,789	\$27,453	
Interest expense	2,585	3,384	4,805	5,530	6,793	
Net interest income	\$22,451	\$23,182	\$22,766	\$22,259	\$20,660	
Provision for loan losses	—	1,660	3,750	6,325	4,350	
Net interest income after provision for loan losses	\$22,451	\$21,522	\$19,016	\$15,934	\$16,310	
Noninterest income	7,462	6,127	5,946	5,837	4,652	
Net revenue	\$29,913	\$27,649	\$24,962	\$21,771	\$20,962	
Noninterest expenses	20,367	18,540	19,269	17,147	16,506	
Income before income taxes	\$9,546	\$9,109	\$5,693	\$4,624	\$4,456	
Applicable income taxes	2,388	2,559	1,371	1,019	1,015	
Net Income	\$7,158	\$6,550	\$4,322	\$3,605	\$3,441	
<b>Performance Ratios:</b>						
Return on average assets	1.23	% 1.15	% 0.76	% 0.65	% 0.65	%
Return on average equity	11.04	% 10.71	% 7.73	% 6.71	% 7.06	%
Shareholders' equity to assets	11.32	% 10.74	% 10.23	% 9.63	% 9.65	%
Dividend payout ratio	36.02	% 37.10	% 54.77	% 61.98	% 63.02	%
Non-performing loans to total loans	1.00	% 0.63	% 0.62	% 2.05	% 1.26	%
Non-performing assets to total assets	1.04	% 0.94	% 0.86	% 1.82	% 1.47	%
<b>Per Share Data:</b>						
Net income, basic	\$2.11	\$1.97	\$1.31	\$1.11	\$1.09	
Net income, diluted	2.10	1.96	1.31	1.11	1.08	
Cash dividends declared	0.76	0.73	0.72	0.69	0.68	
Book value	19.57	19.11	17.67	16.50	16.05	
Market price	22.50	22.00	16.81	16.50	15.75	
Average shares outstanding, basic	3,386,467	3,333,235	3,292,290	3,243,292	3,177,244	
Average shares outstanding, diluted	3,397,742	3,343,212	3,299,998	3,250,868	3,184,534	
<b>Balance Sheet Data:</b>						
Total securities	\$104,790	\$105,531	\$117,654	\$113,776	\$101,210	
Total loans	444,273	418,097	410,424	408,449	404,066	
Total assets	586,444	593,276	568,022	558,840	535,385	
Total deposits	487,587	477,101	448,465	429,296	398,107	
Shareholders' equity	66,406	63,706	58,090	53,829	51,643	





#### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

The purpose of this discussion is to focus on the important factors affecting the financial condition, results of operations, liquidity and capital resources of Eagle Financial Services, Inc. (the "Company"). This discussion should be read in conjunction with the Company's Consolidated Financial Statements and the Notes to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Data, of this Form 10-K.

##### GENERAL

The Company is a bank holding company which owns 100% of the stock of Bank of Clarke County (the "Bank"). Accordingly, the results of operations for the Company are dependent upon the operations of the Bank. The Bank conducts commercial banking business which consists of attracting deposits from the general public and investing those funds in commercial, consumer and real estate loans and corporate, municipal and U.S. government agency securities. The Bank's deposits are insured by the Federal Deposit Insurance Corporation to the extent permitted by law. At December 31, 2013, the Company had total assets of \$586.4 million, net loans of \$438.8 million, total deposits of \$487.6 million and shareholders' equity of \$66.4 million. The Company's net income was \$7.2 million for the year ended December 31, 2013.

##### MANAGEMENT'S STRATEGY

The Company strives to be an outstanding financial institution in its market by building solid sustainable relationships with: (1) its customers, by providing highly personalized customer service, a network of conveniently placed branches and ATMs, a competitive variety of products/services and courteous, professional employees, (2) its employees, by providing generous benefits, a positive work environment, advancement opportunities and incentives to exceed expectations, (3) its communities, by participating in local concerns, providing monetary support, supporting employee volunteerism and providing employment opportunities, and (4) its shareholders, by providing sound profits and returns, sustainable growth, regular dividends and committing to our local, independent status.

##### OPERATING STRATEGY

The Bank is a locally owned and managed financial institution. This allows the Bank to be flexible and responsive in the products and services it offers. The Bank grows primarily by lending funds to local residents and businesses at a competitive price that reflects the inherent risk of lending. The Bank attempts to fund these loans through deposits gathered from local residents and businesses. The Bank prices its deposits by comparing alternative sources of funds and selecting the lowest cost available. When deposits are not adequate to fund asset growth, the Bank relies on borrowings, both short and long term. The Bank's primary source of borrowed funds is the Federal Home Loan Bank of Atlanta which offers numerous terms and rate structures to the Bank.

As interest rates change, the Bank attempts to maintain its net interest margin. This is accomplished by changing the price, terms, and mix of its financial assets and liabilities. The Bank also earns fees on services provided through Eagle Investment Group, which is the Bank's investment management division that offers both trust services and investment sales, mortgage originations and deposit operations. The Bank also incurs noninterest expenses associated with compensating employees, maintaining and acquiring fixed assets, and purchasing goods and services necessary to support its daily operations.

The Bank has a marketing department which seeks to develop new business. This is accomplished through an ongoing calling program whereby account officers visit with existing and potential customers to discuss the products and services offered. The Bank also utilizes traditional advertising such as television commercials, radio ads, newspaper ads, and billboards.

##### LENDING POLICIES

Administration and supervision over the lending process is provided by the Bank's Credit Administration Department. The principal risk associated with the Bank's loan portfolio is the creditworthiness of its borrowers. In an effort to manage this risk, the Bank's policy gives loan amount approval limits to individual loan officers based on their position and level of experience. Credit risk is increased or decreased, depending on the type of loan and prevailing economic conditions. In consideration of the different types of loans in the portfolio, the risk associated with real estate mortgage loans, commercial loans and consumer loans varies based on employment levels, consumer

confidence, fluctuations in the value of real estate and other conditions that affect the ability of borrowers to repay debt.

The Company has written policies and procedures to help manage credit risk. The Company utilizes a loan review process that includes formulation of portfolio management strategy, guidelines for underwriting standards and risk assessment, procedures for ongoing identification and management of credit deterioration, and regular portfolio reviews to establish loss exposure and to ascertain compliance with the Company's policies.

The Bank uses a tiered approach to approve credit requests consisting of individual lending authorities, a senior management loan committee, and a director loan committee. Lending limits for individuals and the Senior Loan Committee are set by the Board of Directors and are determined by loan purpose, collateral type, and internal risk rating of the borrower. The highest individual authority (Category I) is assigned to the Bank's President / Chief Executive Officer, Senior Loan Officer and Senior Credit Officer (approval authority only). Two officers in Category I may combine their authority to approve loan requests to borrowers with credit exposure up to \$1,000,000 on a secured basis and \$500,000 unsecured. Officers in Category II, III, IV, V, VI and VII have lesser authorities and with approval of a Category I officer may extend loans to borrowers with exposure of \$500,000 on a secured basis and \$250,000 unsecured. Loan exposures up to \$1,000,000 may be approved with the concurrence of two, Category I officers. Loans to borrowers with total credit exposures between \$1,000,000 and \$3,000,000 are approved by the Senior Loan Committee consisting of the President, Chief Operating Officer, Senior Loan Officer, Senior Credit Officer, and Chief Financial Officer. Approval of the Senior Loan Committee is required prior to being referred to the Director Loan Committee for approval. Loans exceeding \$3,000,000 and up to the Bank's legal lending limit can be approved by the Director Loan Committee consisting of four directors (three directors constituting a forum). The Director's Loan Committee also reviews and approves changes to the Bank's Loan Policy as presented by management. The following sections discuss the major loan categories within the total loan portfolio:

#### One-to-Four-Family Residential Real Estate Lending

Residential lending activity may be generated by the Bank's loan officer solicitations, referrals by real estate professionals, and existing or new bank customers. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant. The valuation of residential collateral is provided by independent fee appraisers who have been approved by the Bank's Directors Loan Committee. In connection with residential real estate loans, the Bank requires title insurance, hazard insurance and, if applicable, flood insurance. In addition to traditional residential mortgage loans secured by a first or junior lien on the property, the Bank offers home equity lines of credit.

#### Commercial Real Estate Lending

Commercial real estate loans are secured by various types of commercial real estate in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, small shopping centers and churches. Commercial real estate loan originations are obtained through broker referrals, direct solicitation of developers and continued business from customers. In its underwriting of commercial real estate, the Bank's loan to original appraised value ratio is generally 80% or less. Commercial real estate lending entails significant additional risk as compared with residential mortgage lending. Commercial real estate loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Additionally, the repayment of loans secured by income producing properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or the economy, in general. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios, the borrower's creditworthiness, prior credit history and reputation, and the Bank typically requires personal guarantees or endorsements of the borrowers' principal owners.

#### Construction and Land Development Lending

The Bank makes local construction loans, primarily residential, and land acquisition and development loans. The construction loans are secured by residential houses under construction and the underlying land for which the loan was obtained. The average life of most construction loans is less than one year and the Bank offers both fixed and variable rate interest structures. The interest rate structure offered to customers depends on the total amount of these loans outstanding and the impact of the interest rate structure on the Bank's overall interest rate risk. There are two characteristics of construction lending which impact its overall risk as compared to residential mortgage lending. First, there is more concentration risk due to the extension of a large loan balance through several lines of credit to a single developer or contractor. Second, there is more collateral risk due to the fact that loan funds are provided to the borrower based upon the estimated value of the collateral after completion. This could cause an inaccurate estimate of the amount needed to complete construction or an excessive loan-to-value ratio. To mitigate the risks associated with

construction lending, the Bank generally limits loan amounts to 80% of the estimated appraised value of the finished home. The Bank also obtains a first lien on the property as security for its construction loans and typically requires personal guarantees from the borrower's principal owners. Finally, the Bank performs inspections of the construction projects to ensure that the percentage of construction completed correlates with the amount of draws on the construction line of credit.

### Commercial and Industrial Lending

Commercial business loans generally have more risk than residential mortgage loans, but have higher yields. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers. Residential mortgage loans generally are made on the basis of the borrower's ability to make repayment from employment and other income and are secured by real estate whose value tends to be readily ascertainable. In contrast, commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as commercial real estate, accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as residential real estate.

### Consumer Lending

The Bank offers various secured and unsecured consumer loans, which include personal installment loans, personal lines of credit, automobile loans, and credit card loans. The Bank originates its consumer loans within its geographic market area and these loans are generally made to customers with whom the Bank has an existing relationship.

Consumer loans generally entail greater risk than residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by rapidly depreciable assets such as automobiles. In such cases, any repossessed collateral on a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. Consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

The underwriting standards employed by the Bank for consumer loans include a determination of the applicant's payment history on other debts and an assessment of ability to meet existing obligations and payments on the proposed loan. The stability of the applicant's monthly income may be determined by verification of gross monthly income from primary employment, and from any verifiable secondary income. Although creditworthiness of the applicant is the primary consideration, the underwriting process also includes an analysis of the value of the security in relation to the proposed loan amount.

### CRITICAL ACCOUNTING POLICIES

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

The allowance for loan losses is an estimate of the losses that may be sustained in the Company's loan portfolio. As required by GAAP, the allowance for loan losses is accrued when their occurrence is probable and they can be estimated. Impairment losses are accrued based on the differences between the loan balance and the value of its collateral, the present value of future cash flows, or the price established in the secondary market. The Company's allowance for loan losses has three basic components: the general allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when actual events occur. The general allowance uses historical experience and other qualitative factors to estimate future losses and, as a result, the estimated amount of losses can differ significantly from the actual amount of losses which would be incurred in the future. However, the potential for significant differences is mitigated by continuously

updating the loss history of the Company. The specific allowance is based upon the evaluation of specific impaired loans on which a loss may be realized. Factors such as past due history, ability to pay, and collateral value are used to identify those loans on which a loss may be realized. Each of these loans is then evaluated to determine how much loss is estimated to be realized on its disposition. The sum of the losses on the individual loans becomes the Company's specific allowance. This process is inherently subjective and actual losses may be greater than or less than the estimated specific allowance. The unallocated allowance captures losses that are attributable to various economic events which may affect a certain loan type within the loan portfolio or a certain industrial or geographic sector within the Company's market. As the loans, which are affected by these events, are identified or losses are experienced on the loans which are affected by these events, they will be reflected within the specific or general allowances. Note 1 to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Data, of the 2013 Form 10-K, provides additional information related to the allowance for loan losses.

#### FORWARD LOOKING STATEMENTS

The Company makes forward looking statements in this report that are subject to risks and uncertainties. These forward looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals. The words “believes,” “expects,” “may,” “will,” “should,” “projects,” “contemplates,” “anticipates,” “forecasts,” “intends,” or other similar words or terms are intended to identify forward looking statements. These forward looking statements are subject to significant uncertainties because they are based upon or are affected by factors including:

- difficult market conditions in our industry;
- unprecedented levels of market volatility;
- effects of soundness of other financial institutions;
- uncertain outcome of recently enacted legislation to stabilize the U.S. financial system;
- potential impact on us of recently enacted legislation;
- the ability to successfully manage growth or implement growth strategies if the Bank is unable to identify attractive markets, locations or opportunities to expand in the future;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- the successful management of interest rate risk;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- changes in general economic and business conditions in the market area;
- reliance on the management team, including the ability to attract and retain key personnel;
- changes in interest rates and interest rate policies;
- maintaining capital levels adequate to support growth;
- maintaining cost controls and asset qualities as new branches are opened or acquired;
- demand, development and acceptance of new products and services;
- problems with technology utilized by the Bank;
- changing trends in customer profiles and behavior;
- changes in banking and other laws and regulations; and
- other factors described in Item 1A., “Risk Factors,” above.

Because of these uncertainties, actual future results may be materially different from the results indicated by these forward looking statements. In addition, past results of operations do not necessarily indicate future results.

## RESULTS OF OPERATIONS

### Net Income

Net income for 2013 was \$7.2 million, an increase of \$608 thousand or 9.28% over 2012's net income of \$6.6 million. Net income for 2012 increased \$2.3 million or 51.55% from 2011's net income of \$4.3 million. Diluted earnings per share were \$2.10, \$1.96, and \$1.31 for 2013, 2012, and 2011, respectively.

Return on average assets (ROA) measures how efficiently the Company uses its assets to produce net income. Some issues reflected within this efficiency include the Company's asset mix, funding sources, pricing, fee generation, and cost control. The ROA of the Company, on an annualized basis, was 1.23%, 1.15%, and 0.76% for 2013, 2012, and 2011, respectively.

Return on average equity (ROE) measures the utilization of shareholders' equity in generating net income. This measurement is affected by the same factors as ROA with consideration to how much of the Company's assets are funded by the shareholders. The ROE for the Company was 11.04%, 10.71%, and 7.73% for 2013, 2012, and 2011, respectively.

### Net Interest Income

Net interest income, the difference between total interest income and total interest expense, is the Company's primary source of earnings. Net interest income was \$22.5 million for 2013, \$23.2 million for 2012, and \$22.8 million for 2011, which represents a decrease of \$731 thousand or 3.15% and an increase of \$416 thousand or 1.83% for 2013 and 2012, respectively. Net interest income is derived from the volume of earning assets and the rates earned on those assets as compared to the cost of funds. Total interest income was \$25.0 million for 2013, \$26.6 million for 2012, and \$27.6 million for 2011, which represents a decrease of \$1.6 million or 5.76% and \$1.0 million or 3.65% for 2013 and 2012, respectively. Total interest expense was \$2.6 million for 2013, \$3.4 million for 2012, and \$4.8 million for 2011, which represents a decrease of \$799 thousand or 23.61% and \$1.4 million or 29.57% in 2013 and 2012, respectively. The decreases in total interest income and total interest expense during 2013 are driven mainly by the interest rate environment. Refer to the table titled "Volume and Rate Analysis" for further detail on these decreases.

The table titled "Average Balances, Income and Expenses, Yields and Rates" displays the composition of interest earnings assets and interest bearing liabilities and their respective yields and rates for the years ended December 31, 2013, 2012, and 2011.

The net interest margin was 4.24% for 2013, 4.47% for 2012, and 4.40% for 2011. The net interest margin is calculated by dividing tax-equivalent net interest income by total average earnings assets. Tax-equivalent net interest income is calculated by adding the tax benefit on certain securities and loans, whose interest is tax-exempt, to total interest income then subtracting total interest expense. The tax rate used to calculate the tax benefit was 34% for 2013, 2012, and 2011. The table titled "Tax-Equivalent Net Interest Income" reconciles net interest income to tax-equivalent net interest income, which is not a measurement under GAAP, for the years ended December 31, 2013, 2012, and 2011.



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Average Balances, Income and Expenses, Yields and Rates

(dollars in thousands)

	December 31, 2013			December 31, 2012			December 31, 2011		
	Average Balances	Interest Income/ Expense	Average Yield/ Rate	Average Balances	Interest Income/ Expense	Average Yield/ Rate	Average Balances	Interest Income/ Expense	Average Yield/ Rate
Assets:									
Securities:									
Taxable	\$72,630	\$2,242	3.09 %	\$70,134	\$2,571	3.67 %	\$80,146	\$3,108	3.88 %
Tax-Exempt (1)	36,692	1,881	5.13 %	39,281	2,095	5.33 %	38,285	2,117	5.53 %
Total Securities	\$109,322	\$4,123	3.77 %	\$109,415	\$4,666	4.26 %	\$118,431	\$5,225	4.41 %
Loans:									
Taxable	422,692	21,352	5.05 %	413,281	22,387	5.42 %	396,430	22,826	5.76 %
Non-accrual	2,921	—	— %	2,731	—	— %	4,735	—	— %
Tax-Exempt (1)	4,423	269	6.08 %	4,786	306	6.39 %	4,657	307	6.59 %
Total Loans	\$430,036	\$21,621	5.03 %	\$420,798	\$22,693	5.39 %	\$405,822	\$23,133	5.70 %
Federal funds sold	—	—	— %	92	—	— %	5	—	— %
Interest-bearing deposits in other banks	10,048	23	0.23 %	9,420	23	0.24 %	17,219	37	0.21 %
Total earning assets	\$546,485	\$25,767	4.72 %	\$536,994	\$27,382	5.10 %	\$536,742	\$28,395	5.29 %
Allowance for loan losses	(6,957 )			(8,393 )			(7,687 )		
Total non-earning assets	40,573			39,698			43,771		
Total assets	\$580,101			\$568,299			\$572,826		
Liabilities and Shareholders' Equity:									
Interest-bearing deposits:									
NOW accounts	\$83,889	\$103	0.12 %	\$80,500	\$140	0.17 %	\$65,410	\$168	0.26 %
Money market accounts	87,809	120	0.14 %	84,241	210	0.25 %	74,749	336	0.45 %
Savings accounts	59,114	30	0.05 %	52,635	39	0.07 %	47,852	56	0.12 %
Time deposits:									
\$100,000 and more	38,232	241	0.63 %	48,065	380	0.79 %	63,215	618	0.98 %
Less than \$100,000	65,900	648	0.98 %	71,810	817	1.14 %	89,987	1,261	1.40 %
Total interest-bearing deposits	\$334,944	\$1,142	0.34 %	\$337,251	\$1,586	0.47 %	\$341,213	\$2,439	0.71 %
Federal funds purchased and securities sold under agreements to repurchase	1,064	31	2.91 %	10,174	360	3.54 %	12,501	364	2.91 %
Federal Home Loan Bank advances	32,223	1,094	3.40 %	32,960	1,120	3.40 %	48,305	1,685	3.49 %
Trust preferred capital notes	7,217	318	4.41 %	7,217	318	4.41 %	7,217	317	4.39 %
Total interest-bearing liabilities	\$375,448	\$2,585	0.69 %	\$387,602	\$3,384	0.87 %	\$409,236	\$4,805	1.17 %
Noninterest-bearing liabilities:									
Demand deposits	136,242			115,667			104,041		
Other Liabilities	3,581			3,864			3,611		

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Total liabilities	\$515,271		\$507,133		\$516,888
Shareholders' equity	64,830		61,166		55,938
Total liabilities and shareholders' equity	\$580,101		\$568,299		\$572,826
Net interest income		\$23,182		\$23,998	\$23,590
Net interest spread		4.03 %		4.23 %	4.12 %
Interest expense as a percent of average earning assets		0.47 %		0.63 %	0.90 %
Net interest margin		4.24 %		4.47 %	4.40 %

(1) Income and yields are reported on a tax-equivalent basis using a federal tax rate of 34%.

Tax-Equivalent Net Interest Income  
(dollars in thousands)

	December 31,		
	2013	2012	2011
GAAP Financial Measurements:			
Interest Income - Loans	\$21,530	\$22,589	\$23,029
Interest Income - Securities and Other Interest-Earnings Assets	3,506	3,977	4,542
Interest Expense - Deposits	1,142	1,586	2,439
Interest Expense - Other Borrowings	1,443	1,798	2,366
Total Net Interest Income	\$22,451	\$23,182	\$22,766
Non-GAAP Financial Measurements:			
Add: Tax Benefit on Tax-Exempt Interest Income - Loans	\$92	\$104	\$104
Add: Tax Benefit on Tax-Exempt Interest Income - Securities and Other Interest-Earnings Assets	639	712	720
Total Tax Benefit on Tax-Exempt Interest Income	\$731	\$816	\$824
Tax-Equivalent Net Interest Income	\$23,182	\$23,998	\$23,590

The tax-equivalent yield on earning assets decreased 38 basis points from 2012 to 2013 and 19 basis points from 2011 to 2012. The tax-equivalent yield on securities decreased 49 basis points from 2012 to 2013 and 15 basis points from 2011 to 2012. The tax-equivalent yield on loans decreased 36 basis points from 2012 to 2013 and 31 basis points from 2011 to 2012. The decrease in the yield on earning assets, securities, and the loan portfolio was primarily a result of the low interest rate environment that extended through 2013.

The average rate on interest-bearing liabilities decreased 18 basis points from 2012 to 2013 and 30 basis points from 2011 to 2012. These changes were caused primarily by management of the deposit pricing and product mix and the continued low rate environment. An intentional shift in the product mix during 2013 was planned and achieved to move from time deposits to non-maturity deposits. The average rate on total interest-bearing deposits decreased 13 basis points from 2012 to 2013 and 24 basis points from 2011 to 2012. In general, deposit pricing is done in response to monetary policy actions and yield curve changes. Local competition for funds affects the cost of time deposits, which are primarily comprised of certificates of deposit. The Company issues brokered certificates of deposit as a substitute for offering promotional certificates of deposit when their rates are lower. The rates on brokered certificates of deposit are usually comparable with other wholesale funding sources and these funds can be gathered more efficiently without causing existing deposits to reprice. The Company prefers to rely most heavily on non-maturity deposits, which include NOW accounts, money market accounts, and savings accounts. The average balance of non-maturity interest-bearing deposits increased \$13.4 million or 6.18% from \$217.4 million during 2012 to \$230.8 million in 2013 and \$29.4 million or 15.61% from \$188.0 million at December 31, 2011 during 2012. Changes in the average rate on interest-bearing liabilities can also be affected by the pricing on other sources of funds, namely borrowings. The Company from time to time will utilize overnight borrowings in the form of federal funds purchased and retail repurchase agreements. The Company also borrows funds for a longer term through wholesale repurchase agreements, which require marketable securities as collateral. The average rate on these borrowings decreased 63 basis points from 2012 to 2013 and increased 63 basis points from 2011 to 2012. The rate on wholesale repurchase agreements, which matured in January 2013, was fixed at 3.54%, while the cost of federal funds purchased is affected by the Federal Reserve's changes in the federal funds target rate, which remained at 0.25% during 2013. The Company has not borrowed funds through retail repurchase agreements since June 2011. Finally, the Company borrows from the Federal Home Loan Bank through short and long term advances. The average rate on FHLB advances remained stable from 2012 to 2013 and decreased 9 basis points from 2011 to 2012. The average balance on FHLB advances decreased \$737 thousand during 2013 and decreased \$15.3 million during 2012.

The table titled "Volume and Rate Analysis" provides information about the effect of changes in financial assets and liabilities and changes in rates on net interest income. Non-accruing loans are excluded from the average outstanding

loans. Tax-equivalent net interest income decreased \$816 thousand during 2013. The decrease in tax-equivalent net interest income during 2013 is comprised of an increase due to volume of \$925 thousand and a decrease due to rate of \$1.7 million. The change in tax-equivalent net interest income during 2013 was primarily affected by low rates on deposits, Federal Home Loan Bank advances, and taxable loans.

## Volume and Rate Analysis (Tax-Equivalent Basis)

(dollars in thousands)

	2013 vs 2012			2012 vs 2011		
	Increase (Decrease)			Increase (Decrease)		
	Due to Changes in:			Due to Changes in:		
	Volume	Rate	Total	Volume	Rate	Total
<b>Earning Assets:</b>						
<b>Securities:</b>						
Taxable	\$96	\$(425)	\$(329)	\$(375)	\$(162)	\$(537)
Tax-exempt	(136)	(78)	(214)	56	(78)	(22)
<b>Loans:</b>						
Taxable	518	(1,553)	(1,035)	1,130	(1,569)	(439)
Tax-exempt	(23)	(14)	(37)	10	(11)	(1)
Federal funds sold	—	—	—	—	—	—
Interest-bearing deposits in other banks	—	—	—	(20)	6	(14)
Total earning assets	\$455	\$(2,070)	\$(1,615)	\$801	\$(1,814)	\$(1,013)
<b>Interest-Bearing Liabilities:</b>						
NOW accounts	\$6	\$(43)	\$(37)	\$56	\$(84)	\$(28)
Money market accounts	10	(100)	(90)	50	(176)	(126)
Savings accounts	7	(16)	(9)	5	(22)	(17)
<b>Time deposits:</b>						
\$100,000 and more	(70)	(69)	(139)	(132)	(106)	(238)
Less than \$100,000	(62)	(107)	(169)	(231)	(213)	(444)
Total interest-bearing deposits	\$(109)	\$(335)	\$(444)	\$(252)	\$(601)	\$(853)
Federal funds purchased and securities sold under agreements to repurchase	\$(335)	\$6	\$(329)	\$(2)	\$(2)	\$(4)
Federal Home Loan Bank advances	(26)	—	(26)	(523)	(42)	(565)
Trust preferred capital notes	—	—	—	—	1	1
Total interest-bearing liabilities	\$(470)	\$(329)	\$(799)	\$(777)	\$(644)	\$(1,421)
Change in net interest income	\$925	\$(1,741)	\$(816)	\$1,578	\$(1,170)	\$408

## Provision for Loan Losses

The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses as discussed within the Critical Accounting Policies section above. The provision for loan losses was zero for 2013, \$1.7 million for 2012, and \$3.8 million for 2011. Changes in the amount of provision for loan losses during each period reflect the results of the Bank's analysis used to determine the adequacy of the allowance for loan losses. The lower provision for loan losses compared to last year reflects lower specific reserves on remaining impaired loans as well as a lower balance in impaired loans. The Company is committed to maintaining an allowance that adequately reflects the risk inherent in the loan portfolio. This commitment is more fully discussed in the "Asset Quality" section.

## Noninterest Income

Total noninterest income was \$7.5 million, \$6.1 million, and \$5.9 million during 2013, 2012, and 2011, respectively. This represents an increase of \$1.4 million or 21.79% for 2013 and \$207 thousand or 3.50% for 2012. Management reviews the activities which generate noninterest income on an ongoing basis.

The following table provides the components of noninterest income for the twelve months ended December 31, 2013, 2012, and 2011, which are included within the respective Consolidated Statements of Income headings. The following

paragraphs provide information about activities which are included within the respective Consolidated Statements of Income headings.

(dollars in thousands)	2013	2012	\$ Change	% Change	2012	2011	\$ Change	% Change	
Income from fiduciary activities	\$1,186	\$963	\$223	23.16	% \$963	\$907	\$56	6.17	%
Service charges on deposit accounts	1,453	1,509	(56)	(3.71)	% 1,509	1,586	(77)	(4.85)	%
Other service charges and fees	3,864	3,404	460	13.51	% 3,404	3,190	214	6.71	%
Gain (loss) on the sale of bank premises and equipment	(1)	—	(1)	NM	—	76	(76)	NM	
Gain on sale of securities	465	45	420	NM	45	67	(22)	NM	
Other operating income	495	206	289	140.29	% 206	94	112	119.15	%
Total noninterest income	7,462	6,127	1,335	21.79	% 6,127	5,920	207	3.50	%

NM - Not Meaningful

Income from fiduciary activities, generated by trust services offered through Eagle Investment Group, increased by \$223 thousand or 23.16% for 2013. The amount of income from fiduciary activities is determined by the number of active accounts and total assets under management. Also, income can fluctuate due to the number of estates settled within any period. During the first quarter of 2013, the Company determined that it had under-accrued trust fees receivable during 2011 and 2012. An adjustment was made in the first quarter of 2013 to increase the trust fees receivable account and increase the corresponding income from fiduciary activities.

The amount of other services charges and fees is comprised primarily of commissions from the sale of non-deposit investment products, fees received from the Bank's credit card program, fees generated from the Bank's ATM/debit card programs, and fees generated from the origination of mortgage loans for the secondary market. Other service charges and fees increased by \$460 thousand or 13.51% for 2013. ATM/debit card fees increased by \$297 thousand for 2013. In April of 2013, the Company received a signing bonus of \$121 thousand from its current debit card vendor for extending its contract and remaining exclusive to this provider. In addition, the Company recorded the sale of the Bank's merchant processing business. The sale of the merchant portfolio resulted in a net gain of \$399 thousand. Total proceeds from the transaction of \$450 thousand are reflected in other service charges and fees while broker, legal and other related expenses are reflected in non-interest expense. These increases in other service charges and fees were offset by a decrease of \$406 thousand or 58.67% in fees generated from the origination of mortgage loans for the secondary market. This decrease is due to decreased volume in this product for 2013. Other service charges and fees increased by \$214 thousand or 6.71% for 2012. This increase is largely attributable to fees generated from the origination of mortgage loans for the secondary market, due to increased volume in this product for 2012.

In 2013, the Company sold \$4.0 million in available for sale securities for a net gain of \$465 thousand. In 2012, the Company sold \$3.4 million in available for sale securities for a net gain of \$45 thousand. In 2011, the Company sold \$4.8 million in available for sale securities for a net gain of \$67 thousand. During 2011, the Company recorded an impairment charge of \$88 thousand on a corporate security. No impairment charges were recorded during 2013 or 2012.

Other operating income increased \$289 thousand or 140.29% during 2013. During 2013, the Company recorded \$254 thousand of income related to the proceeds received from a bank owned life insurance policy, which was the majority of the increase to other operating income. Other operating income increased \$112 thousand or 119.15% during 2012. This increase resulted mostly from increased income from the Company's investments in Davenport Financial Fund and Banker's Insurance.

Several one time events, as noted above, including the sale of the merchant card portfolio, the receipt of life insurance benefits and the adjustment made to the the trust fees receivable account, have helped to mitigate declining interest income during 2013.

## Noninterest Expenses

Total noninterest expenses were \$20.4 million, \$18.5 million, and \$19.2 million during 2013, 2012, and 2011, respectively. This represents an increase of \$1.9 million or 9.85% during 2013 and a decrease of \$703 thousand or 3.65% during 2012. The efficiency ratio of the Company was 65.36%, 61.06%, and 63.42% for 2013, 2012, and 2011, respectively. The efficiency ratio is calculated by dividing total noninterest expenses by the sum of tax-equivalent net interest income and total noninterest income, excluding certain non-recurring gains and losses. A reconciliation of tax-equivalent net interest income, which is not a measurement under GAAP, to net interest income is presented within the Net Interest Income section above. The following paragraphs provide information about expenses which are included within the respective Consolidated Statements of Income headings.

(dollars in thousands)	2013	2012	\$ Change	% Change	2012	2011	\$ Change	% Change	
Salaries and employee benefits	\$11,451	\$10,634	\$817	7.68	% \$10,634	\$10,609	\$25	0.24	%
Occupancy expenses	1,291	1,147	144	12.55	% 1,147	1,155	(8)	(0.69)	%
Equipment expenses	666	665	1	0.15	% 665	676	(11)	(1.63)	%
Advertising and marketing expenses	548	470	78	16.60	% 470	500	(30)	(6.00)	%
Stationery and supplies	274	289	(15)	(5.19)	% 289	292	(3)	(1.03)	%
ATM network fees	616	528	88	16.67	% 528	546	(18)	(3.30)	%
Other real estate owned expense	40	362	(322)	(88.95)	% 362	159	203	127.67	%
(Gain) loss on the sale of other real estate owned	140	(13)	)153	NM	(13)	)335	(348)	)NM	
FDIC assessment	375	292	83	28.42	% 292	712	(420)	(58.99)	%
Computer software expense	664	463	201	43.41	% 463	507	(44)	(8.68)	%
Bank franchise tax	407	383	24	6.27	% 383	376	7	1.86	%
Professional fees	1,013	1,072	(59)	(5.50)	% 1,072	1,111	(39)	(3.51)	%
Other bank services charges	695	79	616	779.75	% 79	87	(8)	(9.20)	%
Other operating expenses	2,187	2,169	18	0.83	% 2,169	2,178	(9)	(0.41)	%
Total noninterest expenses	\$20,367	\$18,540	\$1,827	9.85	% \$18,540	\$19,243	\$(703)	(3.65)	%

## NM - Not Meaningful

Salaries and employee benefits increased \$817 thousand or 7.68% during 2013. This increase can be attributed to several factors including annual salary increases, salary expenses related to the Purcellville branch which opened in 2013. In 2013, the Company began an accrual for hourly employees due to being paid one week in arrears, which amounted to \$70 thousand.

Occupancy expenses increased \$144 thousand or 12.55% during 2013. Occupancy expenses for the Purcellville branch, which opened in May 2013, were approximately \$150 thousand.

Advertising and marketing expenses increased \$78 thousand or 16.60% during 2013. This category contains numerous expense types such as advertising, public relations, business development, and charitable contributions. The annual budgeted amount of advertising and marketing expenses is directly related to the Company's growth in assets. The total amount of advertising and marketing expenses varies based on planned events and advertising campaigns. Expenses are allocated in a manner which focuses on effectively reaching existing and potential customers within the market and contributing to the community. Advertising expenses have been higher during 2013 due to the opening of the new Purcellville branch.

ATM network fees increased \$88 thousand or 16.67% during 2013. ATM network fees fluctuate based on the usage of ATM and debit cards.

Other real estate owned expenses decreased \$322 thousand or 88.95% during 2013 and increased \$203 thousand or 127.67% during 2012. This fluctuation is due mainly to a valuation allowance of \$283 thousand that was established during 2012. No valuation allowances were established during 2013.





FDIC assessments increased \$83 thousand or 28.42% during 2013 and decreased \$420 thousand or 58.99% during 2012. On December 30 2009, the Company prepaid their estimated quarterly FDIC assessments of \$2.3 million for 2010, 2011, and 2012. The remaining prepaid FDIC balance of \$435 thousand was refunded to the Company on June 28, 2013. During the second quarter of 2012, the Company determined that it had expensed too much of its remaining prepaid FDIC insurance balance during the period of October 1, 2011 through March 31, 2012 and as a result made a \$174 thousand adjustment to increase the prepaid balance and decrease the corresponding expense. The remaining decrease in 2012 versus 2011 was due to a change in the FDIC assessment base from average deposits to average assets less tangible equity as required by the Dodd-Frank Act.

Computer software expense increased \$201 thousand or 43.41% during 2013. As the Company grows and regulations increase, the Company has had to invest in additional software products causing expenses to increase.

Other bank service charges increased \$616 thousand or 779.75% during 2013. Noninterest expense was negatively impacted by the Company's election to prepay a \$10.0 million outstanding advance with the Federal Home Loan Bank of Atlanta. A \$612 thousand prepayment fee was incurred by the Company in December 2013 in conjunction with the repayment of the advance.

#### Income Taxes

Income tax expense was \$2.4 million, \$2.6 million, and \$1.4 million for the years ended December 31, 2013, 2012, and 2011, respectively. The change in income tax expense can be attributed to changes in taxable earnings at the federal statutory income tax rate of 34%. These amounts correspond to an effective tax rate of 25.02%, 28.09%, and 24.08% for 2013, 2012, and 2011, respectively. Note 9 to the Consolidated Financial Statements provides a reconciliation between income tax expense computed using the federal statutory income tax rate and the Company's actual income tax expense during 2013, 2012, and 2011.

#### FINANCIAL CONDITION

##### Assets, Liabilities and Shareholders' Equity

The Company's total assets were \$586.4 million at December 31, 2013, a decrease of \$6.9 million or 1.15% from \$593.3 million at December 31, 2012. Securities decreased \$156 thousand or 0.15% from 2012 to 2013. Loans, net of allowance for loan losses, increased by \$27.3 million or 6.63% from 2012 to 2013. Total liabilities were \$520.0 million at December 31, 2013, compared to \$529.6 million at December 31, 2012. Total shareholders' equity at year end 2013 and 2012 was \$66.4 million and \$63.7 million, respectively.

##### Securities

Total securities at December 31, 2013 were \$102.6 million as compared to \$102.8 million as of December 31, 2012, which represents a decrease of \$156 thousand or 0.15% during 2013. The table titled "Securities Portfolio" shows the carrying value of securities at December 31, 2013, 2012, and 2011. The Company purchased \$26.9 million in securities during 2013. This amount includes \$16.8 million or 62.48% in obligations of U.S. government corporations and agencies, \$2.1 million or 7.64% in mortgage-backed securities and \$8.0 million or 29.88% in obligations of states and political subdivisions. The Company had \$18.4 million in maturities and principal repayments on securities during 2013. This amount includes \$3.7 million or 19.98% in obligations of U.S. government corporations and agencies, \$5.7 million or 30.82% in mortgage-backed securities, \$5.5 million or 30.12% in obligations of states and political subdivisions, \$2.5 million or 13.64% in corporate securities, and \$1.0 million or 5.44% in equity securities. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity as of December 31, 2013. Note 2 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio as of December 31, 2013 and 2012.

##### Securities Portfolio

(dollars in thousands)

	December 31, 2013	2012	2011
Securities available for sale:			
Obligations of U.S. government corporations and agencies	\$34,744	\$23,692	\$18,533
Mortgage-backed securities	15,197	22,207	34,546

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Obligations of states and political subdivisions	43,116	43,501	45,766
Corporate securities	8,423	11,156	13,043
Equity securities	1,118	2,198	2,246
	\$102,598	\$102,754	\$114,134

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The ability to dispose of available for sale securities prior to maturity provides management more options to react to future rate changes and provides more liquidity, when needed, to meet short-term obligations. The Company had a net unrealized gain on available for sale securities of \$0.8 million and \$5.8 million at December 31, 2013 and 2012, respectively. Unrealized gains or losses on available for sale securities are reported within shareholders' equity, net of the related deferred tax effect, as accumulated other comprehensive income.

The table titled "Maturity Distribution and Yields of Securities" shows the maturity period and average yield for the different types of securities in the portfolio at December 31, 2013. Although mortgage-backed securities have definitive maturities, they provide monthly principal curtailments which can be reinvested at a prevailing rate and for a different term.

#### Maturity Distribution and Yields of Securities

(dollars in thousands)

	December 31, 2013										
	Due in one year or less		Due after 1 through 5 years		Due after 5 through 10 years		Due after 10 years and Equity Securities		Total		
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	
Securities available for sale:											
Obligations of U.S. government corporations and agencies	\$2,013	1.85 %	\$13,275	1.80 %	\$17,696	2.17 %	\$1,760	3.36 %	\$34,744	2.08 %	
Mortgage-backed securities	—	— %	231	4.43 %	4,443	2.13 %	10,523	3.30 %	15,197	2.96 %	
Corporate securities	2,034	6.90 %	5,065	6.83 %	1,185	7.00 %	139	— %	8,423	6.84 %	
Obligations of states and political subdivisions, taxable	—	— %	2,260	2.31 %	2,514	4.74 %	2,788	4.55 %	7,562	3.94 %	
Equity securities	—	— %	—	— %	—	— %	1,118	6.94 %	1,118	6.94 %	
Total taxable	\$4,047	4.37 %	\$20,831	3.01 %	\$25,838	2.58 %	\$16,328	3.76 %	\$67,044	3.10 %	
Obligations of states and political subdivisions, tax-exempt (1)	2,815	3.68 %	10,370	3.11 %	19,380	3.36 %	2,989	4.26 %	35,554	3.39 %	
Total	\$6,862	4.09 %	\$31,201	3.04 %	\$45,218	2.90 %	\$19,317	3.84 %	\$102,598	3.20 %	

(1) Yields on tax-exempt securities have been computed on a tax-equivalent basis using a federal tax rate of 34%.

#### Loan Portfolio

The Company's primary use of funds is supporting lending activities from which it derives the greatest amount of interest income. Gross loans were \$444.3 million and \$418.1 million at December 31, 2013 and 2012, respectively. This represents an increase of \$26.2 million or 6.26% for 2013. The ratio of loans to deposits increased during the year from 87.63% to 91.12% at December 31, 2012 and December 31, 2013, respectively. The table titled "Loan Portfolio" shows the composition of the loan portfolio over the last five years.

#### Loan Portfolio

(dollars in thousands)

December 31,

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	2013	2012	2011	2010	2009
Loans secured by real estate:					
Construction and land development	\$27,047	\$30,846	\$31,579	\$31,560	\$34,531
Secured by farmland	9,886	7,030	3,390	4,332	5,636
Secured by 1-4 family residential properties	218,633	214,619	212,638	207,671	205,579
Multifamily	2,850	2,808	4,517	4,908	3,112
Commercial	148,166	124,382	118,043	116,381	109,516
Loans to farmers	1,321	1,525	1,910	1,293	1,284
Commercial and industrial loans	20,865	21,640	22,866	24,449	24,268
Consumer installment loans	13,785	13,307	13,185	14,518	16,115
All other loans	1,720	1,940	2,296	3,337	4,025
Total loans	\$444,273	\$418,097	\$410,424	\$408,449	\$404,066

Loans secured by real estate were \$406.6 million or 91.52% and \$379.7 million or 90.81% of total loans at December 31, 2013 and 2012, respectively. This represents an increase of \$26.9 million or 7.08% for 2013. Consumer installment loans were \$13.8 million or 3.10% and \$13.3 million or 3.18% of total loans at December 31, 2013 and 2012, respectively. This represents an increase of \$478 thousand or 3.59% for 2013. Commercial and industrial loans were \$20.9 million or 4.70% and \$21.6 million or 5.18% of total loans at December 31, 2013 and 2012. This represents a decrease of \$775 thousand or 3.58% for 2013.

The table titled “Maturity Schedule of Selected Loans” shows the different loan categories and the period during which they mature. For loans maturing in more than one year, the table also shows a breakdown between fixed rate loans and floating rate loans. The table indicates that \$349.7 million or 78.71% of the loan portfolio matures within five years. The floating rate loans maturing after five years are primarily comprised of home equity lines of credit.

#### Maturity Schedule of Selected Loans

(dollars in thousands)

	December 31, 2013			Total
	Within 1 Year	After 1 Year Within 5 Years	After 5 Years	
Loans secured by real estate:				
Construction and land development	\$22,881	\$4,032	\$134	\$27,047
Secured by farmland	1,496	7,686	704	9,886
Secured by 1-4 family residential properties	22,986	145,151	50,496	218,633
Multifamily	307	1,900	643	2,850
Commercial	25,756	82,942	39,468	148,166
Loans to farmers	572	749	—	1,321
Commercial and industrial loans	10,172	8,398	2,295	20,865
Consumer installment loans	1,369	12,070	346	13,785
All other loans	—	1,227	493	1,720
	\$85,539	\$264,155	\$94,579	\$444,273
For maturities over one year:				
Floating rate loans		\$12,762	\$13,091	\$25,853
Fixed rate loans		251,393	81,488	332,881
		\$264,155	\$94,579	\$358,734

#### Asset Quality

The Company has policies and procedures designed to control credit risk and to maintain the quality of its loan portfolio. These include underwriting standards for new originations and ongoing monitoring and reporting of asset quality and adequacy of the allowance for loan losses. There were \$6.1 million in total non-performing assets, which consist of nonaccrual loans, foreclosed property, and repossessed assets at December 31, 2013. This is an increase of \$710 thousand when compared to the December 31, 2012 balance of \$5.3 million. This increase resulted mostly from the increase in nonaccrual loans, offset by decreases in foreclosed property as discussed below.

Nonaccrual loans were \$4.4 million at December 31, 2013 and \$2.4 million at 2012. The gross amount of interest income that would have been recognized on nonaccrual loans was \$129 thousand for 2013 and \$75 thousand for 2012. None of this interest income was included in net income for 2013 or 2012. A total of 15 loans were placed in nonaccrual during 2013. The majority of these loans (11) had balances of less than \$100 thousand. Two large relationships were added to nonaccrual at December 31, 2013 totaling \$2.4 million. In addition, six loans totaling \$1.2 million were removed from nonaccrual status during 2013. Management evaluates the financial condition of these borrowers and the value of any collateral on these loans. The results of these evaluations are used to estimate the amount of losses which may be realized on the disposition of these nonaccrual loans. Nonaccrual loans that were

evaluated for impairment at December 31, 2013 totaled \$4.4 million and had \$524 thousand in specific allocations.

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Foreclosed property decreased to \$1.6 million at December 31, 2013, compared to \$2.9 million at December 31, 2012. Six foreclosed properties were sold during 2013, while only one foreclosed property was acquired. When the property is sold, the difference between the amount of other real estate owned and the settlement proceeds is recognized as a gain or loss on the sale of other real estate owned. A net loss of \$140 thousand was recognized on the sale of other real estate owned during 2013. A net gain of \$13 thousand was recognized on the sale of other real estate owned during 2012.

Total loans past due 90 days or more and still accruing interest were \$11 thousand or 0.00%, \$208 thousand or 0.05%, and \$94 thousand or 0.23% of total loans at December 31, 2013, 2012, and 2011, respectively. The loans past due 90 days or more and still accruing interest are well secured and in the process of collection; therefore, they are not classified as nonaccrual.

#### Nonperforming and Other Assets

Nonperforming assets consist of nonaccrual loans, other real estate owned (foreclosed properties), and repossessed assets. The table titled "Nonperforming Assets" shows the amount of nonperforming assets and loans past due 90 days and accruing interest outstanding during the last five years. The table also shows the ratios for the allowance for loan losses as a percentage of nonperforming assets and nonperforming assets as a percentage of loans outstanding and other real estate owned.

Loans are placed on non-accrual status when collection of principal and interest is doubtful, generally when a loan becomes 90 days past due. There are three negative implications for earnings when a loan is placed on non-accrual status. First, all interest accrued but unpaid at the date that the loan is placed on non-accrual status is either deducted from interest income or written off as a loss. Second, accruals of interest are discontinued until it becomes certain that both principal and interest can be repaid. Finally, there may be actual losses that require additional provisions for loan losses to be charged against earnings.

For real estate loans, upon foreclosure, the balance of the loan is transferred to "Other Real Estate Owned" ("OREO") and carried at the lower of the outstanding loan balance or the fair market value of the property based on current appraisals and other current market trends, less selling costs. If a write down of the OREO property is necessary at the time of foreclosure, the amount is charged-off against the allowance for loan losses. A review of the recorded property value is performed in conjunction with normal loan reviews, and if market conditions indicate that the recorded value exceeds the fair market value, additional write downs of the property value are charged directly to operations.

In addition, the Company may, under certain circumstances, restructure loans in troubled debt restructurings as a concession to a borrower when the borrower is experiencing financial distress. Formal, standardized loan restructuring programs are not utilized by the Company. Each loan considered for restructuring is evaluated based on customer circumstances and may include modifications to one or more loan provisions. Such restructured loans are included in impaired loans. At December 31, 2013, 2012, 2011, and 2010, the Company had \$6.4 million, \$8.2 million, \$10.7 million, and \$8.5 million in restructured loans, respectively. There were no restructured loans at December 31, 2009.

#### Nonperforming Assets

(dollars in thousands)

	December 31,					
	2013	2012	2011	2010	2009	
Nonaccrual loans	\$4,412	\$2,414	\$2,449	\$8,377	\$5,099	
Other real estate owned and repossessed assets	1,646	2,934	2,423	1,805	2,776	
Total nonperforming assets	\$6,058	\$5,348	\$4,872	\$10,182	\$7,875	
Loans past due 90 days and accruing interest	\$11	\$208	\$94	\$10	\$13	
Allowance for loan losses to nonperforming assets	91	% 123	% 179	% 70	% 76	%



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Non-performing assets to period end loans and other real estate owned	1.36	% 1.27	% 1.18	% 2.48	% 1.94	%
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Other potential problem loans are defined as performing loans that possess certain risks that management has identified that could result in the loans not being repaid in accordance with their terms. Accordingly, these loans are risk rated at a level of substandard or lower. At December 31, 2013, other potential problem loans totaled \$13.3 million. Of the total other potential problem loans, \$9.3 million or 69.65% are currently considered impaired and are disclosed in Note 4 to the Consolidated Financial Statements.

#### Allowance for Loan Losses

The purpose and the methods for measuring the allowance for loans are discussed in the Critical Accounting Policies section above. The table titled "Analysis of Allowance for Loan Losses" shows the activity within the allowance during the last five years, including a breakdown of the loan types which were charged-off and recovered.

Charged-off loans were \$1.3 million, \$4.2 million, and \$3.0 million for 2013, 2012, and 2011, respectively.

Recoveries were \$233 thousand, \$337 thousand, and \$848 thousand for 2013, 2012, and 2011, respectively. Net charge-offs were \$1.1 million, \$3.8 million, and \$2.1 million for 2013, 2012, and 2011, respectively. This represents a decrease in net charge-offs of \$2.7 million or 71.54% for 2013 and an increase of \$1.7 million or 80.64% for 2012.

The allowance for loan losses as a percentage of loans was 1.24%, 1.57%, and 2.13% at the end of 2013, 2012, and 2011, respectively. The decreases in allowance for loan losses as a percentage of total loans from December 31, 2012 to December 31, 2013 is primarily due to charge-offs incurred during 2013 that were supported by specific reserves in the allowance for loan losses during 2012. In addition, while nonperforming assets increased slightly, restructured loans as well as impaired loans decreased at a more rapid pace. The allowance for loan losses at year-end covered net charge-offs during the year by 5.04 times for 2013, 1.72 times for 2012, and 1.43 times for 2011. The ratio of net charge-offs to average loans was 0.25% for 2013, 0.91% for 2012, and 0.52% for 2011.

The provision for loan losses for the year ended December 31, 2013 was zero, a decrease of \$1.7 million or 100.00% from December 31, 2012. The lower provision for loan losses compared to last year reflects lower specific reserves on remaining impaired loans as well as a lower balance in impaired loans.

The table titled "Allocation of Allowance for Loan Losses" shows the amount of the allowance for loan losses which is allocated to the indicated loan categories, along with that category's percentage of total loans, at December 31, 2013, 2012, 2011, 2010, and 2009. The amount of allowance for loan losses allocated to each loan category is based on the amount delinquent loans in that loan category, the status of nonperforming assets in that loan category, the historical losses for that loan category, and the financial condition of certain borrowers whose financial condition is monitored on a periodic basis. Management believes that the allowance for loan losses is adequate based on the loan portfolio's current risk characteristics.

Analysis of Allowance for Loan Losses  
 (dollars in thousands)

	December 31,					
	2013	2012	2011	2010	2009	
Balance, beginning of period	\$6,577	\$8,743	\$7,111	\$5,970	\$4,521	
Loans charged-off:						
Commercial, financial and agricultural	403	207	596	1,077	466	
Real estate-construction and land development	20	1,313	710	2,917	1,090	
Real estate-mortgage	796	2,499	1,204	1,239	1,141	
Consumer	103	144	456	242	456	
Total loans charged off	\$1,322	\$4,163	\$2,966	\$5,475	\$3,153	
Recoveries:						
Commercial, financial and agricultural	\$47	\$36	\$137	\$72	\$98	
Real estate-construction and land development	5	4	5	—	—	
Real estate-mortgage	116	213	299	102	—	
Consumer	65	84	407	117	154	
Total recoveries	\$233	\$337	\$848	\$291	\$252	
Net charge-offs	1,089	3,826	2,118	5,184	2,901	
Provision for loan losses	—	1,660	3,750	6,325	4,350	
Balance, end of period	\$5,488	\$6,577	\$8,743	\$7,111	\$5,970	
Ratio of allowance for loan losses to loans outstanding at period end	1.24	% 1.57	% 2.13	% 1.74	% 1.48	%
Ratio of net charge offs to average loans outstanding during the period	0.25	% 0.91	% 0.52	% 1.27	% 0.74	%

 Allocation of Allowance for Loan Losses  
 (dollars in thousands)

	Commercial, Financial, and Agricultural		Real Estate Construction		Real Estate Mortgage		Consumer and Other Loans	
	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans
December 31, 2013	\$555	4.7 %	\$1,032	8.3 %	\$3,562	83.2 %	\$184	3.8 %
December 31, 2012	880	5.2 %	1,280	9.0 %	4,002	81.8 %	229	4.0 %
December 31, 2011	1,077	5.6 %	2,618	8.5 %	4,601	81.7 %	254	4.2 %
December 31, 2010	819	6.0 %	1,386	8.8 %	4,688	80.5 %	218	4.7 %
December 31, 2009	1,417	7.3 %	1,735	8.5 %	2,464	80.1 %	354	4.1 %

## Deposits

Total deposits were \$487.6 million and \$477.1 million at December 31, 2013 and 2012, respectively, which represents an increase of \$10.5 million or 2.20% during 2013. The table titled "Average Deposits and Rates Paid" shows the average deposit balances and average rates paid for 2013, 2012 and 2011.

## Average Deposits and Rates Paid

(dollars in thousands)

	December 31,		2012		2011			
	2013		2012		2011			
	Amount	Rate	Amount	Rate	Amount	Rate		
Noninterest-bearing	\$ 136,242		\$ 115,667		\$ 104,041			
Interest-bearing:								
NOW accounts	83,889	0.12	% 80,500	0.17	% 65,410	0.26	%	
Money market accounts	87,809	0.14	% 84,241	0.25	% 74,749	0.45	%	
Regular savings accounts	59,114	0.05	% 52,635	0.07	% 47,852	0.12	%	
Time deposits:								
\$100,000 and more	38,232	0.63	% 48,065	0.79	% 63,215	0.98	%	
Less than \$100,000	65,900	0.98	% 71,810	1.14	% 89,987	1.4	%	
Total interest-bearing	\$334,944	0.34	% \$337,251	0.47	% \$341,213	0.71	%	
Total deposits	\$471,186		\$452,918		\$445,254			

Noninterest-bearing demand deposits, which are comprised of checking accounts, increased \$12.8 million or 9.51% from \$134.9 million at December 31, 2012 to \$147.7 million at December 31, 2013. Interest-bearing deposits, which include NOW accounts, money market accounts, regular savings accounts and time deposits, decreased \$2.3 million or 0.68% from \$342.2 million at December 31, 2012 to \$339.9 million at December 31, 2013. Total NOW account balances decreased \$6.8 million or 7.39% from \$92.3 million at December 31, 2012 to \$85.5 million at December 31, 2013. Total money market account balances increased \$7.1 million or 8.36% from \$85.0 million at December 31, 2012 to \$92.1 million at December 31, 2013. Total regular savings account balances increased \$9.2 million or 17.07% from \$54.0 million at December 31, 2012 to \$63.2 million at December 31, 2013. Time deposits decreased \$11.9 million or 10.67% from \$111.0 million at December 31, 2012 to \$99.1 million at December 31, 2013. This is comprised of a decrease in certificates of deposit of \$100,000 and more of \$5.3 million or 13.57% from \$39.3 million at December 31, 2012 to \$34.0 million at December 31, 2013 and a decrease in certificates of deposit of less than \$100,000 of \$5.6 million or 8.08% from \$68.8 million at December 31, 2012 to \$63.2 million at December 31, 2013. Pricing decisions made by management and influenced by the low interest rate environment resulted in the decline in certificate of deposits. Brokered certificates of deposits less than \$100,000 increased \$110 thousand or 1.10% from \$10.0 million at December 31, 2012 to \$10.1 million at December 31, 2013. This included \$9.9 million of traditional brokered certificates of deposit and \$208 thousand of certificates obtained through the CDARS network. Brokered certificates of deposits, greater than \$100,000, decreased \$947 thousand or 32.92% from \$2.9 million at December 31, 2012 to \$1.9 million at December 31, 2013. These certificates were obtained through the CDARS network. The Bank joined the CDARS network in 2008, which allows it to offer over \$50 million in FDIC insurance on a certificate of deposit.

The Company attempts to fund asset growth with deposit accounts and focus upon core deposit growth as its primary source of funding. Core deposits consist of checking accounts, NOW accounts, money market accounts, regular savings accounts, and time deposits of less than \$100,000, excluding brokered certificates of deposit. Core deposits totaled \$475.5 million or 97.53% and \$464.2 million or 97.30% of total deposits at December 31, 2013 and 2012, respectively.

The table titled "Maturities of Certificates of Deposit and Other Time Deposits of \$100,000 and Greater" shows the amount of certificates of deposit of \$100,000 and more maturing within the time period indicated at December 31, 2013. The Company's policy is to issue these certificates for terms of twelve months or less, however, exceptions have

been made as indicated by the \$6.9 million which matures over one year. The total amount maturing within one year is \$29.0 million or 80.69% of the total amount outstanding.

Maturities of Certificates of Deposit and Other Time Deposits of \$100,000 and Greater  
(dollars in thousands)

	Within Three Months	Three to Six Months	Six to Twelve Months	Over One Year	Total	Percent of Total Deposits	
December 31, 2013	\$9,973	\$4,991	\$14,019	\$6,936	\$35,919	7.37	%

### CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity on December 31, 2013 was \$66.4 million, reflecting a percentage of total assets of 11.32% as compared to \$63.7 million and 10.74% at December 31, 2012. The common stock's book value per share increased \$0.46 or 2.41% to \$19.57 per share at December 31, 2013 from \$19.11 per share at December 31, 2012. During 2013, the Company paid \$0.76 per share in dividends as compared to \$0.73 per share for 2012 and \$0.72 per share for 2011. The Company has a Dividend Investment Plan that allows participating shareholders to reinvest the dividends in Company stock.

#### Analysis of Capital

(dollars in thousands)

	December 31, 2013	December 31, 2012	
Tier 1 Capital:			
Common stock	\$8,482	\$8,340	
Capital surplus	11,537	10,424	
Retained earnings	46,082	41,494	
Trust preferred capital notes	7,000	7,000	
Total Tier 1 capital	\$73,101	\$67,258	
Tier 2 Capital:			
Allowance for loan losses	\$5,325	\$5,046	
Total Tier 2 capital	\$5,325	\$5,046	
Total risk-based capital	\$78,426	\$72,304	
Risk weighted assets	\$425,778	\$402,132	
Risk Based Capital Ratios:			
Tier 1 risk-based capital ratio	17.17	% 16.73	%
Total risk-based capital ratio	18.42	% 17.98	%
Tier 1 leverage ratio	12.48	% 11.7	%

Federal regulatory risk-based capital guidelines require percentages to be applied to various assets, including off-balance sheet assets, based on their perceived risk in order to calculate risk-weighted assets. Tier 1 capital consists of total shareholders' equity plus qualifying trust preferred securities outstanding less net unrealized gains and losses on available for sale securities, goodwill and other intangible assets. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses and any excess trust preferred securities that do not qualify as Tier 1 capital. The \$7,000,000 in trust preferred securities, issued by the Company during 2007, qualifies as Tier 1 capital because this amount does not exceed 25% of total capital, including the trust preferred securities. Financial institutions must maintain a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a minimum Tier 1 leverage ratio of 4%. The Company's policy requires a Tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10% and a minimum Tier 1 leverage ratio of 5%. The Company monitors these ratios on a quarterly basis and has several strategies, including without limitation the issuance of common stock or trust preferred securities, to ensure that these ratios remain above regulatory minimums. The table titled "Analysis of Capital" shows the components of Tier 1 capital, Tier 2 capital, the amount of total risk-based capital and risk-weighted assets, and the risk based capital ratios for the Company at December 31, 2013 and 2012.

Note 16 to the Consolidated Financial Statements provides additional discussion and analysis of regulatory capital requirements.

#### 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 banks, federal funds sold, securities classified as available for sale and loans maturing within one year. At December 31, 2013 liquid assets totaled \$201.9 million as compared to \$237.0 million at December 31, 2012. These amounts represent 38.81% and 44.74% of total liabilities at December 31, 2013 and 2012, respectively. 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 Federal Home Loan Bank of Atlanta also provides a source of borrowings with numerous rate and term structures. The Company's senior 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.

#### OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

Note 19 to the Consolidated Financial Statements provides information about the off-balance sheet arrangements which arise through the lending activities of the Company. These arrangements increase the degree of both credit and interest rate risk beyond that which is recognized through the financial assets and liabilities on the consolidated balance sheets.

The table titled "Contractual Obligations and Scheduled Payments" presents the Company's contractual obligations and scheduled payment amounts due within the period indicated at December 31, 2013.

Contractual Obligations and Scheduled Payments  
(dollars in thousands)

	December 31, 2013				Total
	Less than One Year	One Year through Three Years	Three Years through Five Years	More than Five Years	
FHLB advances	\$2,250	\$20,000	\$—	\$—	\$22,250
Trust preferred capital notes	—	—	—	7,217	7,217
Securities sold under agreements to repurchase	—	—	—	—	—
Operating leases	52	104	104	725	985

\$2,302      \$20,104      \$104      \$7,942      \$30,452

The \$22.3 million in outstanding FHLB advances is comprised of three (3) advances. Note 8 to the Consolidated Financial Statements discusses the rates, terms, and conversion features on these advances. The trust preferred capital notes are discussed in Note 20 to the Consolidated Financial Statements. The payments due on operating leases are discussed in Note 6 to the Consolidated Financial Statements.



#### Item 7A. Quantitative and Qualitative Disclosures about Market Risk

As the holding company of the Bank, the Company's primary component of market risk is interest rate volatility. Interest rate fluctuations will impact the amount of interest income and expense the Bank receives or pays on almost all of its assets and liabilities and the market value of its interest-earning assets and interest-bearing liabilities, excluding those which have a very short term until maturity. Interest rate risk exposure of the Company is, therefore, experienced at the Bank level. Asset / liability management attempts to maximize the net interest income of the Company by adjusting the volume and price of rate sensitive assets and liabilities. The Company does not subject itself to foreign currency exchange or commodity price risk due to prohibition through policy and the current nature of operations. Note 14 to the Consolidated Financial Statements discusses derivative instruments and hedging activities of the Company. The Company entered into an interest rate swap agreement related to the outstanding trust preferred capital notes during 2008.

The Bank's interest rate management strategy is designed to maximize net interest income and preserve the capital of the Company. The Bank's financial instruments are periodically subjected to various simulations whose results are discussed in the following paragraphs. These models are based on actual data from the Bank's financial statements and assumptions about the performance of certain financial instruments. Prepayment assumptions are applied to all mortgage related assets, which includes real estate loans and mortgage-backed securities. Prepayment assumptions are based on a median rate at which principal payments are received on these assets over their contractual term. The rate of principal payback is assumed to increase when rates fall and decrease when rates rise. Term assumptions are applied to non-maturity deposits, which includes demand deposits, NOW accounts, savings accounts, and money market accounts. Demand deposits and NOW accounts are generally assumed to have a term greater than one year since the total amount outstanding does not fluctuate with changes in interest rates. Savings accounts and money market accounts are assumed to be more interest rate sensitive, therefore, a majority of the amount outstanding is assumed to have a term of less than one year.

The simulation analysis evaluates the potential effect of upward and downward changes in market interest rates on future net interest income. The Bank previously evaluated change in net interest income by gradually ramping rates up or down over a 12 or 24 month period. The Bank now views the immediate shock of rates as a more effective measure of interest rate risk exposure. The analysis assesses the impact on net interest income over a 12 month period after an immediate increase or "shock" in rates, of 100 basis points up to 400 basis points. The shock down 200 to 400 basis points analysis is not meaningful as interest rates are at historic lows and cannot decrease another 200 to 400 basis points and therefore only an immediate decrease or "shock" of 100 basis points is disclosed. The simulation analysis results are presented in the table below:

#### Year 1 Net Interest Income Simulation (dollars in thousands)

Assumed Market Interest Rate Shock	Change in Net Interest Income		
	Dollars	Percent Change	
-100 BP	\$(770	) 3.63	%
+100 BP	62	0.29	%
+200 BP	115	0.54	%
+300 BP	220	1.04	%
+400 BP	311	1.46	%

The Bank uses simulation analysis to assess earnings at risk and economic value of equity (EVE) analysis to assess economic value at risk. This analysis method allows management to regularly monitor the direction and magnitude of the Bank's interest rate risk exposure. The modeling techniques cannot be measured with complete precision. Maturity and repricing characteristics of assets and liabilities, prepayments on amortizing assets, non-maturity deposit sensitivity and loan and deposit pricing are key assumptions used in acquiring this analysis. There is a realm of uncertainty in using these assumptions but the analysis does provide the Bank with the ability to estimate interest rate

risk position over time.

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The table below examines the Economic Value of Equity (EVE). The EVE of the balance sheet is defined as the discounted present value of expected asset cash flows minus the discounted present value of the expected liability cash flows. The analysis involves changing the interest rates used in determining the expected cash flows and in discounting the cash flows. The model indicates an exposure to falling interest rates. The model also indicates an exposure to rates rising with all rising interest rate shocks as well. These results are driven primarily by the relative change in value of the Bank's core deposit base as rates rise.

Static EVE Change

(dollars in thousands)

Assumed Market Interest Rate Shift	Change in EVE		
	Dollars		Percent Change
-100 BP Shock	\$(6,797	)	(7.02)%
+100 BP Shock	(1,098	)	(1.13)%
+200 BP Shock	(3,749	)	(3.87)%
+300 BP Shock	(6,292	)	(6.50)%
+400 BP Shock	(8,926	)	(9.22)%



Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Eagle Financial Services, Inc.

Berryville, Virginia

We have audited the accompanying consolidated balance sheets of Eagle Financial Services, Inc. and its subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013. The management of Eagle Financial Services, Inc. and its subsidiaries (the Company) is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Eagle Financial Services, Inc. and its subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America.

/s/ SMITH ELLIOTT KEARNS & COMPANY, LLC

SMITH ELLIOTT KEARNS & COMPANY, LLC

Chambersburg, Pennsylvania

March 26, 2014



## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

December 31, 2013 and 2012

(dollars in thousands, except share amounts)

	2013	2012
Assets		
Cash and due from banks	\$9,295	\$9,782
Interest-bearing deposits with other institutions	4,948	38,908
Total cash and cash equivalents	14,243	48,690
Securities available for sale, at fair value	102,598	102,754
Restricted investments	2,192	2,777
Loans	444,273	418,097
Allowance for loan losses	(5,488	) (6,577
Net Loans	438,785	411,520
Bank premises and equipment, net	17,214	16,545
Other real estate owned, net of allowance	1,646	2,928
Other assets	9,766	8,062
Total assets	\$586,444	\$593,276
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest bearing demand deposits	\$147,698	\$134,871
Savings and interest bearing demand deposits	240,749	231,249
Time deposits	99,140	110,981
Total deposits	\$487,587	\$477,101
Federal funds purchased and securities sold under agreements to repurchase	—	10,000
Federal Home Loan Bank advances	22,250	32,250
Trust preferred capital notes	7,217	7,217
Other liabilities	2,984	3,002
Total liabilities	\$520,038	\$529,570
Shareholders' Equity		
Preferred stock, \$10 par value; 500,000 shares authorized and unissued	\$—	\$—
Common stock, \$2.50 par value; authorized 10,000,000 shares; issued 2013, 3,392,780; issued 2012, 3,336,022	8,482	8,340
Surplus	11,537	10,424
Retained earnings	46,082	41,494
Accumulated other comprehensive income	305	3,448
Total shareholders' equity	\$66,406	\$63,706
Total liabilities and shareholders' equity	\$586,444	\$593,276
See Notes to Consolidated Financial Statements		

## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## Consolidated Statements of Income

Years Ended December 31, 2013, 2012, and 2011

(dollars in thousands, except per share amounts)

	2013	2012	2011
Interest and Dividend Income			
Interest and fees on loans	\$21,530	\$22,589	\$23,029
Interest and dividends on securities available for sale:			
Taxable interest income	2,055	2,187	2,695
Interest income exempt from federal income taxes	1,241	1,383	1,397
Dividends	187	384	413
Interest on deposits in banks	23	23	37
Total interest and dividend income	\$25,036	\$26,566	\$27,571
Interest Expense			
Interest on deposits	1,142	1,586	2,439
Interest on federal funds purchased and securities sold under agreements to repurchase	31	360	364
Interest on Federal Home Loan Bank advances	1,094	1,120	1,685
Interest on trust preferred capital notes	135	148	137
Interest on interest rate swap	183	170	180
Total interest expense	\$2,585	\$3,384	\$4,805
Net interest income	\$22,451	\$23,182	\$22,766
Provision For Loan Losses	—	1,660	3,750
Net interest income after provision for loan losses	\$22,451	\$21,522	\$19,016
Noninterest Income			
Income from fiduciary activities	\$1,186	\$963	\$907
Service charges on deposit accounts	1,453	1,509	1,586
Other service charges and fees	3,864	3,404	3,190
(Loss) gain on sale of bank premises and equipment	(1	) —	76
Gain on sale of securities	465	45	67
Other operating income	495	206	94
Total noninterest income	\$7,462	\$6,127	\$5,920
Noninterest Expenses			
Salaries and employee benefits	\$11,451	\$10,634	\$10,609
Occupancy expenses	1,291	1,147	1,155
Equipment expenses	666	665	676
Advertising and marketing expenses	548	470	500
Stationery and supplies	274	289	292
ATM network fees	616	528	546
Other real estate owned expense	40	362	159
Loss (gain) on the sale of other real estate owned	140	(13	) 335
FDIC assessment	375	292	712
Computer software expense	664	463	507
Bank franchise tax	407	383	376
Professional fees	1,013	1,072	1,111
Other bank service charges	695	79	87
Other operating expenses	2,187	2,169	2,178
Total noninterest expenses	\$20,367	\$18,540	\$19,243



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Income before income taxes	\$9,546	\$9,109	\$5,693
Income Tax Expense	2,388	2,559	1,371
Net income	\$7,158	\$6,550	\$4,322
Earnings Per Share			
Net income per common share, basic	\$2.11	\$1.97	\$1.31
Net income per common share, diluted	\$2.10	\$1.96	\$1.31
See Notes to Consolidated Financial Statements			

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## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

Years Ended December 31, 2013, 2012, and 2011

(dollars in thousands)

	2013	2012	2011
Net income	\$7,158	\$6,550	\$4,322
Other comprehensive (loss) income:			
Changes in benefit obligations and plan assets for defined benefit and post retirement benefit plans, net of deferred income taxes (benefit) of \$0, (\$4), and \$146 for the years ended December 31, 2013, 2012, and 2011, respectively		(7	) 275
Unrealized (loss) gain on available for sale securities, net of deferred income taxes (benefit) of (\$1,687), \$289, and \$885 for the years ended December 31, 2013, 2012, and 2011, respectively	(3,275	) 560	1,717
Change in fair value of interest rate swap, net of deferred income taxes (benefit) of \$69, (\$19), and (\$140) for the years ended December 31, 2013, 2012 and 2011, respectively	132	(36	) (271
Total other comprehensive (loss) income	(3,143	) 517	1,721
Total comprehensive income	\$4,015	\$7,067	\$6,043
See Notes to Consolidated Financial Statements			

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
Consolidated Statements of Changes in Shareholders' Equity  
Years Ended December 31, 2013, 2012, and 2011  
(dollars in thousands, except per share amounts)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2010	\$8,124	\$9,076	\$35,419	\$ 1,210	\$53,829
Net income			\$4,322		4,322
Other comprehensive income				\$ 1,721	1,721
Issuance of restricted stock, stock incentive plan (9,291 shares)	23	(23 )			—
Income tax expense on vesting of restricted stock		(3 )			(3 )
Stock based compensation expense		166			166
Issuance of common stock, dividend investment plan (38,703 shares)	96	508			604
Issuance of common stock, employee benefit plan (5,184 shares)	13	76			89
Retirement of common stock (15,663 shares)	(39 )	(232 )			(271 )
Dividends declared (\$0.72 per share)			(2,367 )		(2,367 )
Balance, December 31, 2011	\$8,217	\$9,568	\$37,374	\$ 2,931	\$58,090
Net income			6,550		6,550
Other comprehensive income				517	517
Restricted stock awards, stock incentive plan (10,963 shares)	28	(28 )			—
Income tax benefit on vesting of restricted stock		4			4
Stock-based compensation expense		242			242
Issuance of common stock, dividend investment plan (31,887 shares)	80	546			626
Issuance of common stock, employee benefit plan (6,180 shares)	15	92			107
Dividends declared (\$0.73 per share)			(2,430 )		(2,430 )
Balance, December 31, 2012	\$8,340	\$10,424	\$41,494	\$ 3,448	\$63,706
Net income			7,158		7,158
Other comprehensive (loss)				(3,143 )	(3,143 )
Restricted stock awards, stock incentive plan (13,699 shares)	34	(34 )			—
Income tax benefit on vesting of restricted stock		35			35
Income tax benefit on disqualifying disposition of stock options exercised		5			5
Stock options exercised (3,872 shares)	10	59			69
Stock-based compensation expense		305			305

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Issuance of common stock, dividend investment plan (30,627 shares)	77	585			662
Issuance of common stock, employee benefit plan (8,560 shares)	21	158			179
Dividends declared (\$0.76 per share)			(2,570	)	(2,570 )
Balance, December 31, 2013	\$8,482	\$11,537	\$46,082	\$ 305	\$66,406
See Notes to Consolidated Financial Statements					

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## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

Years Ended December 31, 2013, 2012, and 2011

(dollars in thousands)

	2013	2012	2011	
Cash Flows from Operating Activities				
Net income	\$7,158	\$6,550	4,322	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation	803	821	843	
Amortization of intangible and other assets	150	136	91	
Provision for loan losses	—	1,660	3,750	
Loss (gain) on the sale of other real estate owned	140	(13	) 335	
Loss (gain) on the sale and disposal of assets	1	2	(76	)
(Gain) on the sale of securities	(465	) (45	) (67	)
Stock-based compensation expense	305	242	166	
Premium amortization on securities, net	146	191	111	
Deferred tax benefit (liability)	1,190	350	(317	)
Changes in assets and liabilities:				
(Increase) decrease in other assets	(1,392	) 602	2,594	
Increase (decrease) in other liabilities	183	937	(13	)
Net cash provided by operating activities	\$8,219	\$11,433	\$11,739	
Cash Flows from Investing Activities				
Proceeds from maturities and principal payments of securities available for sale	\$18,389	\$20,997	\$40,166	
Proceeds from the sale of securities available for sale	3,987	3,357	4,849	
Purchases of securities available for sale	(26,863	) (12,271	) (46,798	)
Proceeds from the sale of restricted securities	585	743	461	
Proceeds from the sale of equipment	—	—	445	
Purchases of bank premises and equipment	(1,492	) (2,201	) (964	)
Proceeds from the sale of other real estate owned	1,167	895	3,167	
Proceeds from the sale of repossessed assets	26	71	216	
Net (increase) in loans	(27,290	) (13,213	) (8,139	)
Net cash (used in) investing activities	\$(31,491	) \$(1,622	) \$(6,597	)
Cash Flows from Financing Activities				
Net increase in demand deposits, money market and savings accounts	\$22,327	\$48,725	\$34,592	
Net (decrease) in certificates of deposit	(11,841	) (20,089	) (15,422	)
Net (decrease) in federal funds purchased and securities sold under agreements to repurchase	(10,000	) —	(4,395	)
Net (decrease) in Federal Home Loan Bank advances	(10,000	) (10,000	) (10,000	)
Issuance of common stock, employee benefit plan	179	107	89	
Stock options exercised	69	—	—	
Retirement of common stock	—	—	(271	)
Cash dividends paid	(1,909	) (1,805	) (1,764	)
Net cash (used in) provided by financing activities	\$(11,175	) \$16,938	\$2,829	
See Notes to Consolidated Financial Statements				



## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows (continued)

Years Ended December 31, 2013, 2012, and 2011

(dollars in thousands)

	2013	2012	2011	
(Decrease) increase in cash and cash equivalents	\$ (34,447	) \$ 26,749	\$ 7,971	
Cash and Cash Equivalents				
Beginning	48,690	21,941	13,970	
Ending	\$ 14,243	\$ 48,690	\$ 21,941	
Supplemental Disclosures of Cash Flow Information				
Cash payments for:				
Interest	\$ 2,704	\$ 3,436	\$ 4,885	
Income taxes	\$ 2,097	\$ 2,210	\$ 1,100	
Supplemental Schedule of Noncash Investing and Financing Activities:				
Unrealized (loss) gain on securities available for sale	\$ (4,962	) \$ 849	\$ 2,602	
Change in fair value of interest rate swap	\$ 201	\$ (55	) \$ (411	)
Other real estate acquired in settlement of loans	\$ 25	\$ 1,715	\$ 4,045	
Issuance of common stock, dividend investment plan	\$ 662	\$ 626	\$ 604	
See Notes to Consolidated Financial Statements				





NOTE 1. Nature of Banking Activities and Significant Accounting Policies

Eagle Financial Services, Inc. (the “Company” or “Corporation”) and Subsidiaries grant commercial, financial, agricultural, residential and consumer loans to customers in Virginia and the Eastern Panhandle of West Virginia. The loan portfolio is well diversified and generally is collateralized by assets of the customers. The loans are expected to be repaid from cash flows or proceeds from the sale of selected assets of the borrowers.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to accepted practices within the banking industry.

Principles of Consolidation

The Company owns 100% of Bank of Clarke County (the “Bank”) and Eagle Financial Statutory Trust II. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions between the Company and the Bank have been eliminated. Eagle Financial Statutory Trust II is accounted for under the provisions of GAAP. The subordinated debt of Eagle Financial Statutory Trust II is reflected as a liability of the Company.

Trust Assets

Securities and other property held by the Eagle Investment Group in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold, and interest bearing deposits. Generally, federal funds are purchased and sold for one-day periods.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be “other than temporary” are reflected in earnings as realized losses. In estimating “other than temporary” impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery of fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Bank is required to maintain an investment in the capital stock of certain correspondent banks. No readily available market exists for this stock and it has no quoted market value. The investment in these securities is recorded at cost and they are reported on the Company’s consolidated balance sheet as restricted investments.

Loans

The Company grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout the Counties of Clarke, Frederick, and Loudoun, Virginia and the City of Winchester, Virginia. The ability of the Company’s debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination and commitment fees and direct loan costs are being recognized as collected and incurred. The use of this method of recognition does not produce results that are materially different from results which would have been produced if such costs and fees were deferred and amortized as an adjustment of the loan yield over the life of the related loan.



The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

#### Risks by Loan Portfolio Segments

##### One-to-Four-Family Residential Real Estate Lending

Residential mortgage loans generally are made on the basis of the borrower's ability to make repayment from employment and other income and are secured by real estate whose value tends to be readily ascertainable. As part of the application process, information is gathered concerning income, employment and credit history of the applicant. The valuation of residential collateral is provided by independent fee appraisers who have been approved by the Bank's Directors Loan Committee.

##### Commercial Real Estate Lending

Commercial real estate lending entails significant additional risk as compared with residential mortgage lending. Commercial real estate loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Additionally, the repayment of loans secured by income producing properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or the economy, in general.

##### Construction and Land Development Lending

There are two characteristics of construction lending which impact its overall risk as compared to residential mortgage lending. First, there is more concentration risk due to the extension of a large loan balance through several lines of credit to a single developer or contractor. Second, there is more collateral risk due to the fact that loan funds are provided to the borrower based upon the estimated value of the collateral after completion. This could cause an inaccurate estimate of the amount needed to complete construction or an excessive loan-to-value ratio. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of the estimated appraised value of the finished home.

##### Commercial and Industrial Lending

Commercial business loans generally have more risk than residential mortgage loans, but have higher yields. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of the borrower. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as commercial real estate, accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as residential real estate.

##### Consumer Lending

Consumer loans generally entail greater risk than residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by rapidly depreciable assets such as automobiles. In such cases, any repossessed collateral on a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation.

##### Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The

allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are impaired. An allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience and other qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. 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.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair market value less estimated liquidation costs of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

#### Bank Premises and Equipment

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets. Estimated useful lives range from 10 to 39 years for buildings and 3 to 10 years for furniture and equipment.

#### Other Real Estate Owned

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the fair value of the property, less selling costs at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell.

Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized.

During 2013, there were no other real estate owned properties that were in the process of being developed by the Bank. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in the net expenses from foreclosed assets.

#### Retirement Plans

The Company had a non-contributory defined benefit pension plan that covers eligible employees. Effective December 31, 2006, the pension plan was amended so that no further benefits would accrue under the plan and no additional employees could become participants. The plan was terminated during 2011 after receiving final IRS approval. Refer to Note 10 for a description of the termination of the Company's pension plan. The Company also sponsors a 401(k) savings plan under which eligible employees may defer a portion of their compensation on a pretax basis. The Company also provides a match to participants in this plan, as described more fully in Note 12.

#### Stock-Based Compensation Plan

During 2003, the Company's shareholders approved a stock incentive plan which allows key employees and directors to increase their personal financial interest in the Company. This plan permits the issuance of incentive stock options

and non-qualified stock options and the award of stock appreciation rights, common stock, restricted stock, and phantom stock. The plan, as adopted, authorized the issuance of up to 300,000 shares of common stock. This plan is discussed more fully in Note 11.

#### Income Taxes

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is likely that some positions taken would be sustained upon examination by the applicable taxing authority, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, the Company believes it is “more likely than not” that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the “more likely than not” recognition threshold are measured as the largest amount of tax benefit that is more than fifty percent (50%) likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the balance sheet along with any associated interest and penalties that would be payable to the applicable taxing authority upon examination. Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the statement of income. The Company has no uncertain tax positions.

#### Advertising

The Company follows the policy of charging the costs of advertising to expense as incurred.

#### Reclassifications

Certain reclassifications have been made to the 2012 financial statements to conform to reporting for 2013.

#### Earnings Per Common Share

Basic earnings per share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. The number of potential common shares is determined using the treasury method and relates to outstanding stock options and nonvested restricted stock grants. The following table shows the weighted average number of shares used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock. Potential dilutive common stock had no effect on income available to common shareholders.

	2013	2012	2011
Average number of common shares outstanding	3,386,467	3,333,235	3,292,290
Effect of dilutive common stock	11,275	10,037	7,708
Average number of common shares outstanding used to calculate diluted earnings per share	3,397,742	3,343,272	3,299,998

#### Comprehensive Income

Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities, net of income taxes, are reported within the balance sheet as a separate component of shareholders’ equity. These changes, along with net income, are components of comprehensive income and are reported in the statement of comprehensive income. In addition to net income, the Company’s comprehensive income includes changes in the benefit obligations and plan assets for defined benefit and postretirement benefit plans, unrealized gains or losses on interest rate swaps, and unrealized gains or losses on available for sale securities.

The components of the change in unrealized gains (losses) on securities during 2013, 2012, and 2011 were as follows:

	2013	2012	2011
Gross unrealized (loss) gain	\$(4,497	) \$894	\$2,669
Reclassification adjustment for realized (gain)	(465	) (45	) (67
Net unrealized (loss) gain before taxes	(4,962	) 849	2,602
Tax effect	1,687	(289	) (885
	\$(3,275	) \$560	\$ 1,717





The components of accumulated other comprehensive income, net of deferred taxes, were as follows:

	Unrealized Gain (Loss) on Securities	Change in Fair Value of Interest Rate Swap	Post Retirement Benefit Plan	Total
December 31, 2011	\$3,262	\$(382)	) \$51	\$2,931
2012 Change	560	(36)	) (7)	517
December 31, 2012	3,822	(418)	) 44	3,448
2013 Change	(3,275)	) 132	—	(3,143)
December 31, 2013	\$547	\$(286)	) \$44	\$305

#### Derivative Financial Instruments

The Company follows GAAP to account for derivative and hedging activities. Accordingly, a derivative is recognized in the balance sheet at its fair value. The fair value of a derivative is determined by quoted market prices and mathematical models using current and historical data. If certain hedging criteria are met, including testing for hedge effectiveness, special hedge accounting may be applied. The Company assesses each hedge, both at inception and on an ongoing basis, to determine whether the derivative used in a hedging transaction is effective in offsetting changes in the fair value or cash flows of the hedged item and whether the derivative is expected to remain effective during subsequent periods. The Company discontinues hedge accounting when (a) it determines that a derivative is no longer effective in offsetting changes in fair value or 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. When hedge accounting is discontinued and a derivative remains outstanding, the Company recognizes the derivative in the balance sheet at its fair value and changes in the fair value are recognized in net income.

At inception, the Company designates a derivative as (a) a fair value hedge of recognized assets or liabilities or of unrecognized firm commitments (fair-value hedge) or (b) a hedge of forecasted transactions or variable cash flows to be received or paid in conjunction with recognized assets or liabilities (cash-flow hedge). For a derivative treated as a fair-value hedge, a change in fair value is recorded as an adjustment to the hedged item and recognized in net income. For a derivative treated as a cash flow hedge, the effective portion of a change in fair value is recorded as an adjustment to the hedged item and recognized as a component of accumulated other comprehensive income (loss) within shareholders' equity. For a derivative treated as a cash flow hedge, the ineffective portion of a change in fair value is recorded as an adjustment to the hedged item and recognized in net income. For more information on derivative financial instruments see Note 14 to the Consolidated Financial Statements.

#### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of deferred tax assets.

#### Stock Repurchase Program

On June 19, 2013, the Corporation renewed the stock repurchase program to repurchase up to 150,000 shares of its common stock prior to June 30, 2014. There was no repurchase activity during 2013 and 2012. During 2011, the Company purchased 15,663 shares of its Common Stock under its stock repurchase program at an average price of \$17.28. The maximum number of shares that may yet be purchased under the plan as of December 31, 2013 are 134,337.

#### Recent Accounting Pronouncements

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both

instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2012, the FASB issued ASU 2012-02, "Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment." The amendments in this ASU apply to all entities that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. The amendments in this ASU provide an entity with the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset's fair value when testing an indefinite-lived intangible asset for impairment. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued ASU 2013-01, "Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." The amendments in this ASU clarify the scope for derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements and securities borrowing and securities lending transactions that are either offset or subject to netting arrangements. An entity is required to apply the amendments for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in the consolidated financial statements.

In July 2013, the FASB issued ASU 2013-10, "Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes." The amendments in this ASU permit the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to interest rates on direct Treasury obligations of the U.S. government and the London Interbank Offered Rate. The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate under Topic 815. The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU 2013-11, "Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." The amendments in this ASU provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to

use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

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

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

## NOTE 2. Securities

Amortized costs and fair values of securities available for sale at December 31, 2013 and 2012 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
December 31, 2013 (in thousands)				
Obligations of U.S. government corporations and agencies	\$35,890	\$439	\$(1,585)	) \$34,744
Mortgage-backed securities	14,896	422	(121)	) 15,197
Obligations of states and political subdivisions	42,442	969	(295)	) 43,116
Corporate securities	7,495	928	—	8,423
Equity securities	1,044	74	—	1,118
	\$101,767	\$2,832	\$(2,001)	) \$102,598
December 31, 2012 (in thousands)				
Obligations of U.S. government corporations and agencies	\$22,781	\$911	\$—	\$23,692
Mortgage-backed securities	20,978	1,229	—	22,207
Obligations of states and political subdivisions	41,185	2,327	(11)	) 43,501
Corporate securities	9,963	1,193	—	11,156
Equity securities	2,054	144	—	2,198
	\$96,961	\$5,804	\$(11)	) \$102,754

Carrying amounts of restricted securities at December 31, 2013 and 2012 were as follows:

	December 31, 2013 (in thousands)	December 31, 2012
Federal Reserve Bank Stock	\$344	\$344
Federal Home Loan Bank Stock	1,708	2,293
Community Bankers' Bank Stock	140	140
	\$2,192	\$2,777

The amortized cost and fair value of securities available for sale at December 31, 2013, by contractual maturity, are shown below. Maturities may differ from contractual maturities in mortgage-backed securities because the mortgages underlying the securities may be called or repaid without any penalties.

	Amortized Cost (in thousands)	Fair Value
Due in one year or less	\$6,782	\$6,862
Due after one year through five years	30,087	31,201
Due after five years through ten years	45,862	45,218
Due after ten years	17,992	18,199
Equity securities	1,044	1,118
	\$101,767	\$102,598

During the twelve months ended December 31, 2013, the Company sold \$4.0 million in available for sale securities for a net gain of \$465 thousand. During the twelve months ended December 31, 2012, the Company sold \$3.4 million in available for sale securities for a net gain of \$45 thousand. During the twelve months ended December 31, 2011, the Company sold \$4.8 million in available for sale securities for a net gain of \$67 thousand. The net gain amount included an impairment charge of \$88 thousand on a corporate security.

The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at December 31, 2013 and 2012 were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2013 (in thousands)						
Obligations of U.S. government corporations and agencies	\$23,235	\$1,551	\$1,967	\$34	\$25,202	\$1,585
Mortgage-backed securities	2,828	121	—	—	2,828	121
Obligations of states and political subdivisions	8,439	252	466	43	8,905	295
Corporate securities	—	—	—	—	—	—
Equity securities	—	—	—	—	—	—
	\$34,502	\$1,924	\$2,433	\$77	\$36,935	\$2,001
December 31, 2012 (in thousands)						
Obligations of U.S. government corporations and agencies	\$—	\$—	\$—	\$—	\$—	\$—
Mortgage-backed securities	—	—	—	—	—	—
Obligations of states and political subdivisions	495	6	274	5	769	11
Corporate securities	—	—	—	—	—	—
Equity securities	—	—	—	—	—	—
	\$495	\$6	\$274	\$5	\$769	\$11

Gross unrealized losses on available for sale securities included fifty-one (51) and two (2) debt securities at December 31, 2013 and December 31, 2012, respectively. The Company evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The Company's mortgage-backed securities are issued by U.S. government agencies, which guarantee payments to investors regardless of the status of the underlying mortgages. Consideration is given to the length of time and the amount of an unrealized loss, the financial condition of the issuer, and the intent and ability of the Company to retain its investment in the issuer long enough to allow for an anticipated recovery in fair value. The fair value of a security reflects its liquidity as compared to similar instruments, current market rates on similar instruments, and the creditworthiness of the issuer. Absent any change in the liquidity of a security or the creditworthiness of the issuer, prices will decline as market rates rise and vice-versa. The primary cause of the unrealized losses at December 31, 2013 and December 31, 2012 was changes in market interest rates. Since the losses can be primarily attributed to changes in market interest rates and not expected cash flows or an issuer's financial condition, the unrealized losses are deemed to be temporary. The continuing economic recession involving housing, liquidity and credit were also a contributing factor to the unrealized losses on these securities at December 31, 2013 and December 31, 2012. The Company monitors the financial condition of these issuers continuously and will record other-than-temporary impairment if the recovery of value is unlikely.

The Company's securities are exposed to various risks, such as interest rate, market, currency and credit risks. Due to the level of risk associated with certain securities and the level of uncertainty related to changes in the value of securities, it is at least reasonably possible that changes in risks in the near term would materially affect securities reported in the financial statements. In addition, recent economic uncertainty and market events have led to unprecedented volatility in currency, commodity, credit and equity markets culminating in failures of some banking



and financial services firms and government intervention to solidify others. These events underscore the level of investment risk associated with the current economic environment, and accordingly the level of risk in the Company's securities.

Securities having a carrying value of \$5.1 million at December 31, 2013 were pledged to secure securities sold under agreements to repurchase and for other purposes required by law.

## NOTE 3. Loans

The composition of loans at December 31, 2013 and 2012 was as follows:

	December 31, 2013	2012
	(in thousands)	
Mortgage loans on real estate:		
Construction and land development	\$27,047	\$30,846
Secured by farmland	9,886	7,030
Secured by 1-4 family residential properties	218,633	214,619
Multifamily	2,850	2,808
Commercial	148,166	124,382
Loans to farmers	1,321	1,525
Commercial and industrial loans	20,865	21,640
Consumer installment loans	13,785	13,307
All other loans	1,720	1,940
	\$444,273	\$418,097
Less: Allowance for loan losses	5,488	6,577
	\$438,785	\$411,520

## NOTE 4. Allowance for Loan Losses

Changes in the allowance for loan losses for the years December 31, 2013, 2012 and 2011 were as follows:

	December 31, 2013	2012	2011
	(in thousands)		
Balance, beginning	\$6,577	\$8,743	\$7,111
Provision charged to operating expense	—	1,660	3,750
Recoveries added to the allowance	233	337	848
Loan losses charged to the allowance	(1,322	) (4,163	) (2,966
Balance, ending	\$5,488	\$6,577	\$8,743



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Nonaccrual and past due loans by class at December 31, 2013 and December 31, 2012 were as follows:

December 31, 2013 (in thousands)								
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Current	Total Loans	90 or More Days Past Due Still Accruing	Nonaccrual Loans
Commercial - Non Real Estate:								
Commercial & Industrial	\$ 143	\$—	\$ 1,162	\$ 1,305	\$ 19,560	\$ 20,865	\$—	\$ 1,288
Commercial Real Estate:								
Owner Occupied	364	—	1,270	1,634	90,811	92,445	—	1,269
Non-owner occupied	99	185	—	284	55,437	55,721	—	185
Construction and Farmland:								
Residential	—	—	—	—	7,860	7,860	—	—
Commercial	—	—	—	—	29,073	29,073	—	157
Consumer:								
Installment	95	9	11	115	13,670	13,785	11	6
Residential:								
Equity Lines	202	25	—	227	31,997	32,224	—	179
Single family	1,995	180	693	2,868	183,541	186,409	—	1,328
Multifamily	—	—	—	—	2,850	2,850	—	—
All Other Loans	—	—	—	—	3,041	3,041	—	—
Total	\$ 2,898	\$ 399	\$ 3,136	\$ 6,433	\$ 437,840	\$ 444,273	\$ 11	\$ 4,412
December 31, 2012 (in thousands)								
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Current	Total Loans	90 or More Past Due Still Accruing	Nonaccrual Loans
Commercial - Non Real Estate:								
Commercial & Industrial	\$ 822	\$ 225	\$—	\$ 1,047	\$ 20,593	\$ 21,640	\$—	\$ 230
Commercial Real Estate:								
Owner Occupied	610	374	90	1,074	84,090	85,164	—	90
Non-owner occupied	234	582	—	816	38,402	39,218	—	209
Construction and Farmland:								
Residential	—	—	—	—	9,706	9,706	—	—
Commercial	93	44	—	137	28,033	28,170	—	131

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Consumer:								
Installment	116	10	9	135	13,172	13,307	9	—
Residential:								
Equity Lines	109	—	—	109	31,593	31,702	—	287
Single family	4,059	733	524	5,316	177,601	182,917	199	1,467
Multifamily	—	—	—	—	2,808	2,808	—	—
All Other Loans	—	—	—	—	3,465	3,465	—	—
Total	\$6,043	\$1,968	\$ 623	\$8,634	\$409,463	\$ 418,097	\$ 208	\$ 2,414

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Allowance for loan losses by segment at December 31, 2013 and December 31, 2012 were as follows:

As of and for the Twelve Months Ended December 31, 2013 (in thousands)								
	Construction and Farmland	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$ 1,280	\$ 2,820	\$ 1,182	\$ 880	\$ 107	\$ 122	\$ 186	\$ 6,577
Charge-Offs	(20 )	(507 )	(289 )	(403 )	(85 )	(18 )	—	(1,322 )
Recoveries	5	109	7	47	54	11	—	233
Provision	(233 )	(197 )	437	31	26	(33 )	(31 )	—
Ending balance	\$ 1,032	\$ 2,225	\$ 1,337	\$ 555	\$ 102	\$ 82	\$ 155	\$ 5,488
Ending balance:								
Individually evaluated for impairment	\$ 218	\$ 627	\$ 299	\$ 334	\$ —	\$ —	\$ —	\$ 1,478
Ending balance:								
collectively evaluated for impairment	\$ 814	\$ 1,598	\$ 1,038	\$ 221	\$ 102	\$ 82	\$ 155	\$ 4,010
Financing receivables:								
Ending balance	\$ 36,933	\$ 221,483	\$ 148,166	\$ 20,865	\$ 13,785	\$ 3,041	\$ —	\$ 444,273
Ending balance:								
individually evaluated for impairment	\$ 2,674	\$ 4,922	\$ 4,750	\$ 1,347	\$ —	\$ 6	\$ —	\$ 13,699
Ending balance:								
collectively evaluated for impairment	\$ 34,259	\$ 216,561	\$ 143,416	\$ 19,518	\$ 13,785	\$ 3,035	\$ —	\$ 430,574

As of and for the Twelve Months Ended December 31, 2012 (in thousands)								
	Construction and Farmland	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$ 2,618	\$ 3,544	\$ 1,057	\$ 1,077	\$ 131	\$ 123	\$ 193	\$ 8,743
Charge-Offs	(1,313 )	(1,381 )	(1,118 )	(207 )	(116 )	(28 )	—	(4,163 )
Recoveries	4	67	146	36	73	11	—	337
Provision	(29 )	590	1,097	(26 )	19	16	(7 )	1,660
Ending balance	\$ 1,280	\$ 2,820	\$ 1,182	\$ 880	\$ 107	\$ 122	\$ 186	\$ 6,577
Ending balance:	\$ 141	\$ 1,176	\$ 305	\$ 737	\$ —	\$ —	\$ —	\$ 2,359
Individually								

evaluated for impairment								
Ending balance:								
collectively evaluated for impairment	\$1,139	\$1,644	\$877	\$143	\$107	\$122	\$186	\$4,218
Financing receivables:								
Ending balance	\$37,876	\$217,427	\$124,382	\$21,640	\$13,307	\$3,465	\$—	\$418,097
Ending balance individually evaluated for impairment	\$1,326	\$7,695	\$5,246	\$985	\$—	\$—	\$—	\$15,252
Ending balance collectively evaluated for impairment	\$36,550	\$209,732	\$119,136	\$20,655	\$13,307	\$3,465	\$—	\$402,845

Impaired loans by class at December 31, 2013 and December 31, 2012 were as follows:

	As of and for the Year Ended December 31, 2013 (in thousands)				
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$126	\$145	\$—	\$329	\$8
Commercial Real Estate:					
Owner Occupied	2,246	2,273	—	2,512	118
Non-owner occupied	1,396	1,398	—	1,498	91
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	2,392	2,401	—	2,420	97
Residential:					
Equity lines	289	290	—	460	16
Single family	3,060	3,100	—	3,531	146
Multifamily	—	—	—	—	—
Other Loans	6	6	—	7	1
	\$9,515	\$9,613	\$—	\$10,757	\$477
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$1,221	\$1,221	\$334	\$1,271	\$59
Commercial Real Estate:					
Owner Occupied	—	—	—	—	—
Non-owner occupied	1,108	1,111	299	1,126	49
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	282	283	218	308	18
Residential:					
Equity lines	74	74	74	217	7
Single family	1,499	1,508	553	1,530	71
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$4,184	\$4,197	\$1,478	\$4,452	\$204
Total:					
Commercial	\$1,347	\$1,366	\$334	\$1,600	\$67
Commercial Real Estate	4,750	4,782	299	5,136	258
Construction and Farmland	2,674	2,684	218	2,728	115
Residential	4,922	4,972	627	5,738	240
Other	6	6	—	7	1
Total	\$13,699	\$13,810	\$1,478	\$15,209	\$681



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	As of and for the Year Ended December 31, 2012 (in thousands)				
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$—	\$—	\$—	\$—	\$—
Commercial Real Estate:					
Owner Occupied	1,632	1,636	—	2,323	130
Non-owner occupied	2,290	2,296	—	2,378	147
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	1,102	1,103	—	1,159	18
Residential:					
Equity lines	287	287	—	469	1
Single family	4,406	4,417	—	5,683	210
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$9,717	\$9,739	\$—	\$12,012	\$506
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$985	\$994	\$737	\$1,062	\$53
Commercial Real Estate:					
Owner Occupied	—	—	—	—	—
Non-owner occupied	1,324	1,327	305	1,337	38
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	224	225	141	227	9
Residential:					
Equity lines	358	359	252	366	12
Single family	2,644	2,652	924	2,674	125
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$5,535	\$5,557	\$2,359	\$5,666	\$237
Total:					
Commercial	\$985	\$994	\$737	\$1,062	\$53
Commercial Real Estate	5,246	5,259	305	6,038	315
Construction and Farmland	1,326	1,328	141	1,386	27
Residential	7,695	7,715	1,176	9,192	348
Other	—	—	—	—	—
Total	\$15,252	\$15,296	\$2,359	\$17,678	\$743

Recorded investment is defined as the summation of the principal balance, accrued interest, and net deferred loan fees or costs. For the year ended December 31, 2011, the average recorded investment of impaired loans was \$20.9 million. The interest income recognized on impaired loans was \$846 thousand in 2011.



When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is in nonaccrual status, all payments are applied to principal under the cost-recovery method. For financial statement purposes, the recorded investment in nonaccrual loans is the actual principal balance reduced by payments that would otherwise have been applied to interest. When reporting information on these loans to the applicable customers, the unpaid principal balance is reported as if payments were applied to principal and interest under the original terms of the loan agreements. Therefore, the unpaid principal balance reported to the customer would be higher than the recorded investment in the loan for financial statement purposes. When the ultimate collectability of the total principal of the impaired loan is not in doubt and the loan is in nonaccrual status, contractual interest is credited to interest income when received under the cash-basis method.

The Company uses a rating system for evaluating the risks associated with non-consumer loans. Consumer loans are not evaluated for risk unless the characteristics of the loan fall within classified categories. Descriptions of these ratings are as follows:

Pass	Pass loans exhibit acceptable operating trends, balance sheet trends, and liquidity. Sufficient cash flow exists to service the loan. All obligations have been paid by the borrower in an as agreed manner.
Watch	Watch loans exhibit income volatility, negative operating trends, and a highly leveraged balance sheet. A higher level of supervision is required for these loans as the potential for a negative event could impact the borrower's ability to repay the loan.
Special mention	Special mention loans exhibit a potential weakness, if left uncorrected, may negatively affect the borrower's ability to repay its debt obligation. The risk of default is not imminent and the borrower still demonstrates sufficient cash flow to support the loan.
Substandard	Substandard loans exhibit well defined weaknesses and have a high probability of default. The borrowers exhibit adverse financial trends but still have the ability to service debt obligations.
Doubtful	Doubtful loans exhibit all of the characteristics inherent in substandard loans but the weaknesses make collection or full liquidation highly questionable.
Loss	Loss loans are considered uncollectible and of such little value that its continuance as a bankable asset is not warranted.

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Credit quality information by class at December 31, 2013 and December 31, 2012 was as follows:

INTERNAL RISK RATING GRADES	As of December 31, 2013 (in thousands)		Special Mention	Substandard	Doubtful	Loss	Total	
	Pass	Watch						
Commercial - Non Real Estate:								
Commercial & Industrial	\$ 16,565	\$ 2,820	\$ 86	\$ 106	\$ 1,288	\$—	\$ 20,865	
Commercial Real Estate:								
Owner Occupied	73,998	12,036	3,322	1,820	1,269	—	92,445	
Non-owner occupied	31,484	14,922	5,557	3,758	—	—	55,721	
Construction and Farmland:								
Residential	7,738	122	—	—	—	—	7,860	
Commercial	24,252	1,353	1,196	2,186	86	—	29,073	
Residential:								
Equity Lines	30,458	708	415	480	163	—	32,224	
Single family	157,273	11,505	11,046	5,775	810	—	186,409	
Multifamily	1,946	904	—	—	—	—	2,850	
All other loans	3,041	—	—	—	—	—	3,041	
Total	\$ 346,755	\$ 44,370	\$ 21,622	\$ 14,125	\$ 3,616	\$—	\$ 430,488	
							Performing	Nonperforming
							\$ 13,670	\$ 115
Consumer Credit Exposure by Payment Activity	As of December 31, 2012 (in thousands)							
INTERNAL RISK RATING GRADES	Pass	Watch	Special Mention	Substandard	Doubtful	Loss	Total	
Commercial - Non Real Estate:								
Commercial & Industrial	\$ 16,132	\$ 2,289	\$ 1,099	\$ 1,891	\$ 229	\$—	\$ 21,640	
Commercial Real Estate:								
Owner Occupied	72,916	6,503	1,737	3,918	90	—	85,164	
Non-owner occupied	22,810	5,303	4,332	6,773	—	—	39,218	
Construction and Farm land:								
Residential	9,548	158	—	—	—	—	9,706	
Commercial	21,155	1,777	854	4,384	—	—	28,170	
Residential:								
Equity Lines	30,165	426	172	843	96	—	31,702	
Single family	148,904	12,048	10,672	10,780	513	—	182,917	
Multifamily	1,905	903	—	—	—	—	2,808	
All other loans	3,465	—	—	—	—	—	3,465	
Total	\$ 327,000	\$ 29,407	\$ 18,866	\$ 28,589	\$ 928	\$—	\$ 404,790	
							Performing	Nonperforming

Consumer Credit Exposure by Payment Activity

\$13,172

\$135

One consumer loan was rated as special mention for \$3 thousand and one consumer loan was rated as doubtful for \$6 thousand at December 31, 2013. One consumer loan was rated as substandard for \$8 thousand at December 31, 2012.

## NOTE 5. Troubled Debt Restructurings

All loans deemed a troubled debt restructuring, or “TDR”, are considered impaired, and are evaluated for collateral and cash-flow sufficiency. A loan is considered a TDR when the Company, for economic or legal reasons related to a borrower’s financial difficulties, grants a concession to the borrower that the Company would not otherwise consider. All of the following factors are indicators that the Bank has granted a concession (one or multiple items may be present):

• The borrower receives a reduction of the stated interest rate to a rate less than the institution is willing to accept at the time of the restructure for a new loan with comparable risk.

• The borrower receives an extension of the maturity date or dates at a stated interest rate lower than the current market interest rate for new debt with similar risk characteristics.

• The borrower receives a reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement.

• The borrower receives a deferral of required payments (principal and/or interest).

• The borrower receives a reduction of the accrued interest.

There were twenty (20) troubled debt restructured loans totaling \$6.4 million at December 31, 2013. At December 31, 2012, there were twenty-three (23) troubled debt restructured loans totaling \$8.2 million. Five loans, totaling \$1.7 million, were in nonaccrual status at December 31, 2013. Two loans, totaling \$311 thousand, were in nonaccrual status at December 31, 2012. There were no outstanding commitments to lend additional amounts to troubled debt restructured borrowers at December 31, 2013.

The following tables set forth information on the Company’s troubled debt restructurings by class of financing receivable occurring during the years ended December 31, 2013 and 2012:

		For the Year Ended December 31, 2013 (in thousands)		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Impairment Accrued
Construction and Farmland				
Commercial	2	\$1,608	\$1,608	\$54
Residential				
Equity	1	184	184	—
Single family	2	338	338	—
Total	5	\$2,130	\$2,130	\$54
		For the Year Ended December 31, 2012 (in thousands)		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Impairment Accrued
Commercial Real Estate				
Owner Occupied	1	\$162	\$162	\$—
Construction and Farmland				

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Commercial	1	95	95	—
Residential				
Single family	1	91	91	—
Total	3	\$348	\$348	\$—

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During the twelve months ended December 31, 2013, the Company restructured five loans by granting concessions to borrowers experiencing financial difficulties. One commercial construction and farmland loan was modified by extending the term of the loan and keeping the loan on interest only payments. One commercial construction and farmland loan was modified by granting a lower interest rate. One single family residential loan was modified by changing the amortization period and granting a lower interest rate. One single family residential loan was modified by forgiving a portion of the loan balance and extending the term of the loan. One residential equity loan was modified by changing payments to interest-only in order to reduce the monthly payment for a period of time.

During the twelve months ended December 31, 2012, the Company restructured three loans by granting concessions to borrowers experiencing financial difficulties. One residential loan was modified by granting an interest rate reduction. In addition, one construction and farmland loan and one owner-occupied commercial real estate loan was modified by changing the amortization period to reduce the payment amount.

Loans by class of financing receivable modified as TDRs within the previous 12 months and for which there was a payment default during the stated periods were:

	For the Year Ended December 31, 2013 (in thousands)	
	Number of Contracts	Recorded Investment
Construction and Farmland:		
Commercial	2	\$1,614
Total	2	\$1,614
	For the Year Ended December 31, 2012 (in thousands)	
	Number of Contracts	Recorded Investment
Commercial Real Estate:		
Non-owner occupied	1	\$162
Construction and Farmland:		
Commercial	1	87
Residential:		
Single family	4	863
Total	6	\$1,112

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.



## NOTE 6. Bank Premises and Equipment, Net

The major classes of bank premises and equipment and the total accumulated depreciation at December 31, 2013 and 2012 were as follows:

	December 31,	
	2013	2012
	(in thousands)	
Land	\$4,865	\$3,727
Buildings and improvements	16,795	16,943
Furniture and equipment	7,654	7,198
	\$29,314	\$27,868
Less accumulated depreciation	12,100	11,323
Bank premises and equipment, net	\$17,214	\$16,545

Depreciation expense on buildings and improvements was \$434 thousand, \$432 thousand, and \$443 thousand for the years ended 2013, 2012, and 2011, respectively. Depreciation expense on furniture and equipment was \$368 thousand, \$389 thousand, and \$400 thousand for the years ended 2013, 2012, and 2011, respectively.

The Bank leases certain facilities under operating leases, which expire at various dates through 2032. These leases require payment of certain operating expenses and contain renewal options. The total minimum rental commitment at December 31, 2013 under these leases was due as follows:

	December 31, 2013
	(in thousands)
2014	\$52
2015	52
2016	52
2017	52
2018	52
Thereafter	725
	\$985

The total building and equipment rental expense was \$138 thousand, \$144 thousand, and \$147 thousand in 2013, 2012, and 2011, respectively.

## NOTE 7. Deposits

The composition of deposits at December 31, 2013 and December 31, 2012 was as follows:

	December 31,	
	2013	2012
	(in thousands)	
Noninterest bearing demand deposits	\$147,698	\$134,871
Savings and interest bearing demand deposits:		
NOW accounts	\$85,459	\$92,275
Money market accounts	92,125	85,021
Regular savings accounts	63,165	53,953
	\$240,749	\$231,249
Time deposits:		
Balances of less than \$100,000	\$63,221	\$68,780
Balances of \$100,000 and more	35,919	42,201
	\$99,140	\$110,981
	\$487,587	\$477,101



Time deposits with balances of less than \$100,000 include \$10.1 million and \$10.0 million in brokered certificates of deposit at December 31, 2013 and 2012, respectively. Time deposits with balances of \$100,000 and more include \$1.9 million and \$2.9 million in brokered certificates of deposit at December 31, 2013 and 2012, respectively.

The outstanding balance of time deposits at December 31, 2013 was due as follows:

	December 31, 2013 (in thousands)
2014	\$80,308
2015	10,548
2016	4,158
2017	2,341
2018	1,518
Thereafter	267
	\$99,140

Deposit overdrafts reclassified as loans totaled \$169 thousand and \$117 thousand at December 31, 2013 and 2012, respectively.

#### NOTE 8. Borrowings

The Company, through its subsidiary bank, borrows funds in the form of federal funds purchased, securities sold under agreements to repurchase and Federal Home Loan Bank advances.

Federal fund lines of credit are extended to the Bank by nonaffiliated banks with which a correspondent banking relationship exists. The line of credit amount is determined by the creditworthiness of the Bank and, in particular, its regulatory capital ratios, which are discussed in Note 16. Federal funds purchased generally mature each business day. The following table summarizes information related to federal funds purchased for the years ended December 31, 2013 and 2012:

	December 31,		
	2013	2012	
	(dollars in thousands)		
Balance at year-end	\$—	\$—	
Average balance during the year	270	174	
Average interest rate during the year	0.88	% 0.78	%
Maximum month-end balance during the year	\$5,616	\$6,475	
Gross lines of credit at year-end	36,000	36,000	
Unused lines of credit at year-end	36,000	36,000	

Securities sold under agreements to repurchase are borrowings in which the Bank obtains funds by selling securities and simultaneously agreeing to repurchase the securities for an agreed upon term at a given price which includes interest. The Company had no funds from customers through retail repurchase agreements at December 31, 2013. Generally, the term for retail repurchase agreements is the next business day. The Company had no funds from a larger financial institution through a wholesale repurchase agreement at December 31, 2013. The amount of borrowings through securities sold under agreements to repurchase is restricted by the amount of securities which are designated for these transactions.

The following table summarizes information related to securities sold under agreement to repurchase for the years ended December 31, 2013 and 2012:

	December 31,		
	2013	2012	
	(dollars in thousands)		
Balance at year-end	\$—	\$10,000	
Average balance during the year	795	10,000	
Average interest rate during the year	3.58	% 3.59	%
Maximum month-end balance during the year	\$—	\$10,000	
Securities underlying the agreements at year-end:			
Carrying value	—	12,118	
Fair value	—	12,985	

As of December 31, 2013, Company had remaining credit availability in the amount of \$73.9 million at the Federal Home Loan Bank of Atlanta. This line may be utilized for short and/or long-term borrowing. Advances on the line are secured by all of the Company's eligible first lien residential real estate loans on one-to-four-unit, single-family dwellings; multi-family dwellings; home equity lines of credit; and commercial real estate loans. The amount of the available credit is limited to a percentage of the estimated market value of the loans as determined periodically by the FHLB of Atlanta. The amount of the available credit is also limited to 20% of total Bank assets.

The Company had \$22.3 million in borrowings with the FHLB at December 31, 2013, which matures as follows: \$2.3 million in 2014 and \$20.0 million in 2015. The Company had \$20.0 million in long-term borrowings with the FHLB at December 31, 2013. The interest rates on the outstanding long-term advances at December 31, 2013 ranged from 3.02% to 3.03%. The weighted average interest rate on outstanding long-term advances at December 31, 2013 was 3.02%. The Company had \$2.3 million short-term borrowings with the FHLB at December 31, 2013. The weighted average interest rate on outstanding short-term advances at December 31, 2013 was 3.08%.

#### NOTE 9. Income Taxes

The Company files income tax returns with the United States of America and the Commonwealth of Virginia. With few exceptions, the Company is no longer subject to federal, state, or local income tax examinations for years prior to 2010.

The net deferred tax asset at December 31, 2013 and 2012 consisted of the following components:

	December 31,	
	2013	2012
	(in thousands)	
Deferred tax assets:		
Allowance for loan losses	\$1,866	\$2,236
Deferred compensation	125	116
Accrued postretirement benefits	51	51
Home equity origination costs	41	35
Other than temporary impairment	30	876
Interest rate swap	148	216
Other real estate owned expenses	116	122
Other	381	351
	\$2,758	\$4,003
Deferred tax liabilities:		
Property and equipment	\$533	\$520
Securities available for sale	283	1,970

	\$816	\$2,490
Net deferred tax asset	\$1,942	\$1,513

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The Company has not recorded a valuation allowance for deferred tax assets because management believes that it is more likely than not that they will be ultimately realized.

Income tax expense for the years ended December 31, 2013, 2012 and 2011 consisted of the following components:

	December 31, 2013	2012	2011
	(in thousands)		
Current tax expense	\$1,198	\$2,209	\$1,688
Deferred tax expense (benefit)	1,190	350	(317)
	\$2,388	\$2,559	\$1,371

The following table reconciles income tax expense to the statutory federal corporate income tax amount, which was calculated by applying the federal corporate income tax rate to pre-tax income for the years ended December 31, 2013, 2012 and 2011.

	December 31, 2013	2012	2011
	(in thousands)		
Statutory federal corporate tax amount	\$3,246	\$3,097	\$1,936
Tax-exempt interest (income)	(495)	) (563	) (563)
Officer insurance (income) loss	(82	) 7	11
Net tax credits	(312	) —	—
Other	31	18	(13)
	\$2,388	\$2,559	\$1,371

The effective tax rates were 25.02%, 28.09%, and 24.08%, for years ended December 31, 2013, 2012, and 2011, respectively.

#### NOTE 10. Pension and Postretirement Benefit Plans

Effective December 31, 2006, the pension plan was amended and frozen so that no further benefits will accrue under the plan and no additional employees may become participants. The pension plan was terminated effective September 30, 2011 and after receiving final approval from the Internal Revenue Service, distributions in the form of lump-sum cash payments to plan participants, rollovers and purchasing annuity contracts were completed on December 19, 2011. The Company recognized a loss of \$589,000 on the distribution of the plan's assets during 2011. The loss is included in salaries and employee benefits expense on the consolidated statements of income. An additional \$141,000 in expense was incurred during 2011 for the purchase of employee retirement annuities. The expense is included in outside service fees on the consolidated statements of income. There were no expenses related to the pension plan recognized during 2012 or 2013.

The Company provides certain health care and life insurance benefits for nine retired employees who have met certain eligibility requirements. All other employees retiring after reaching age 65 and having at least 15 years of service with the Company will be allowed to stay on the Company's group life and health insurance policies, but will be required to pay premiums. The Company's share of the estimated costs that will be paid after retirement is generally being accrued by charges to expense over the employees' active service periods to the dates they are fully eligible for benefits, except that the Company's unfunded cost that existed at January 1, 1993 is being accrued primarily in a straight-line manner that will result in its full accrual by December 31, 2013.

Generally Accepted Accounting Principles ("GAAP") requires the Company to recognize the funded status (i.e. the difference between the fair value of plan assets and the projected benefit obligations) of its postretirement benefit plans in the consolidated balance sheet, with a corresponding adjustment to accumulated other comprehensive income, net of taxes.

The following amounts that have not been recognized in the net periodic benefit cost of the postretirement benefit plan for the year ended December 31, 2013 but are included in other comprehensive income: unrecognized net actuarial gain of \$44 thousand. The transition obligation included in other comprehensive income and expected to be recognized in the net periodic benefit cost of the postretirement benefit plan during 2014 is \$4 thousand.





The following tables provide the components of net periodic benefit cost of the pension plan and postretirement benefit plan for the years ended December 31, 2013, 2012, and 2011:

	Pension Plan			Postretirement Benefits Plan		
	2013	2012	2011	2013	2012	2011
	(in thousands)					
Components of Net Periodic Benefit Cost:						
Service cost	\$—	\$—	\$—	\$—	\$—	\$—
Interest cost	—	—	101	4	5	6
Expected return on plan assets	—	—	(83	) —	—	—
Amortization of prior service costs	—	—	—	—	—	—
Amortization of transition obligation	—	—	—	—	—	—
Recognized net loss due to settlement	—	—	141	—	—	—
Amortization of net actuarial loss	—	—	572	(7	) (8	) (11
Net periodic benefit cost	\$—	\$—	\$731	\$(3	) \$(3	) \$(5

The net periodic benefit cost for the pension plan was calculated using the following assumptions; weighted average discount rate of 6.10% for 2011 and expected long-term return on plan assets of 5.00% for 2011. Due to the amendment of the pension plan, no rate of compensation increase was assumed.

The benefit obligation for the postretirement benefit plan was calculated using a weighted average discount rate of 2.75% for 2013, 3.50% for 2012, and 4.25% for 2011. For measurement purposes, a 10.00% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2014, 10.00% for 2015, 8.00% for 2016, 8.00% for 2017, and 6.00% for 2018 and thereafter. If these rates were increased by 1.00% in each year, the benefit obligation at December 31, 2013 would have increased by \$5 thousand and the net periodic benefit cost for 2013 would have increased by less than \$1 thousand. If these rates were decreased by 1.00% in each year, the benefit obligation at December 31, 2013 would have decreased by \$4 thousand and the net periodic benefit cost for 2013 would have decreased by less than \$1 thousand.

All plan assets were distributed to pension plan beneficiaries during 2011 and no future payments are expected. Estimated future benefit payments at December 31, 2013, which reflect expected future service, as appropriate, were as follows:

	Postretirement Benefits (in thousands)
2014	\$15
2015	15
2016	15
2017	14
2018	14
2019 - 2023	54

## NOTE 11. Stock-Based Compensation

The exercise price of stock options granted under this plan, both incentive and non-qualified, cannot be less than the fair market value of the common stock on the date that the option is granted. The maximum term for an option granted under this plan is ten years and options granted may be subject to a vesting schedule. All of the non-qualified stock options granted under the plan had a ten year term and were subject to a vesting period. The following table summarizes options outstanding at December 31, 2013, 2012, and 2011:

	2013			2012		2011	
	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	20,000	\$21.59		22,000	\$21.59	22,000	\$21.59
Granted	—	—		—	—	—	—
Exercised	(3,872 )	21.63		—	—	—	—
Forfeited	(6,128 )	21.63		(2,000 )	21.59	—	—
Outstanding, end of year	10,000	\$21.55		20,000	\$21.59	22,000	\$21.59
Exercisable, end of year	10,000	\$21.55	\$9,500	20,000	\$21.59	22,000	\$21.59
Weighted average fair value of options granted during the year		\$—			\$—		\$—

The aggregate intrinsic value in the table is equal to the amount that would have been received by the option holders had all options been exercised on December 31, 2013. It is derived from the amount by which the current market value of the underlying stock exceeds the exercise price of the option. This amount fluctuates in relation to the market value of the Company's stock.

The following table summarizes options outstanding and exercisable at December 31, 2013:

Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$21.55	10,000	0.75	\$21.55	10,000	\$21.55

Restricted Stock provides grantees with rights to shares of common stock upon completion of a service period or achievement of Company performance measures. During the restriction period, all shares are considered outstanding and dividends are paid to the grantee. Outside directors are periodically granted restricted shares which vest over a period of less than six months. During 2013, executive officers were granted restricted shares which vest over a three year service period and restricted shares which vest based on meeting performance measures over a three year period. The following table presents the activity for Restricted Stock for the years ended December 31, 2013, 2012 and 2011:

	Twelve Months Ended December 31,					
	2013		2012		2011	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested, beginning of period	16,500	\$16.53	13,700	\$16.11	12,772	\$16.89
Granted	14,900	22.06	14,500	17.87	12,300	16.76
Vested	(13,699 )	18.30	(10,963 )	17.79	(9,291 )	17.55
Forfeited	(651 )	16.75	(737 )	16.25	(2,081 )	18.38
Nonvested, end of period	17,050	\$19.92	16,500	\$16.53	13,700	\$16.11

The Company recognizes compensation expense over the restricted period. Compensation expense was \$305 thousand, \$242 thousand, and \$166 thousand during December 31, 2013, 2012, and 2011, respectively. The total grant date fair value of Restricted Stock which vested was \$251 thousand and \$195 thousand for the years ended December 31, 2013 and 2012, respectively. Unrecognized compensation cost related to unvested Restricted Stock was \$65 thousand at December 31, 2013. This amount is expected to be recognized over a weighted average period of 1.01 year.

#### NOTE 12. Employee Benefits

The Company has established an Employee Stock Ownership Plan (ESOP) to provide additional retirement benefits to substantially all employees. Contributions can be made to the Bank of Clarke County Employee Retirement Trust to be used to purchase the Company's common stock. There were no contributions in 2013, 2012, and 2011.

The Company sponsors a 401(k) savings plan under which eligible employees may defer a portion of salary on a pretax basis, subject to certain IRS limits. Prior to January 1, 2007, the Company matched 50 percent of employee contributions, on a maximum of six percent of salary deferred, with Company common stock or cash, as elected by each employee. The shares for this purpose are provided principally by the Company's employee stock ownership plan (ESOP), supplemented, as needed, by newly issued shares. In conjunction with amending the pension plan, the 401(k) plan was amended, effective January 1, 2007, to include a non-elective safe-harbor employer contribution and an age-weighted employer contribution. Each December 31<sup>st</sup>, qualifying employees will receive a non-elective safe-harbor contribution equal to three percent of their salary for that year. Also, each December 31<sup>st</sup>, qualifying employees will receive an additional contribution based on their age and years of service. The percentage of salary for the age-weighted contribution increases on both factors, age and years of service, with a minimum of one percent of salary and a maximum of ten percent of salary. Contributions under the plan amounted to \$888 thousand in 2013, \$867 thousand in 2012, and \$739 thousand in 2011.

The Company has established an Executive Supplemental Income Plan for certain key employees. Benefits are to be paid in monthly installments following retirement or death. The agreement provides that if employment is terminated for reasons other than death or disability prior to age 65, the amount of benefits could be reduced or forfeited. The executive supplemental income benefit liability was \$93 thousand and \$121 thousand at December 31, 2013 and 2012, respectively. The executive supplemental income benefit expense, based on the present value of the retirement benefits, was \$8 thousand in 2013, \$16 thousand in 2012, and \$13 thousand in 2011. The plan is unfunded; however,

life insurance has been acquired on the lives of these employees in amounts sufficient to discharge the plan's obligations.

## NOTE 13. Commitments and Contingencies

In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities, which are not reflected in the accompanying financial statements. These commitments and contingent liabilities include various guarantees, commitments to extend credit and standby letters of credit. The Company does not anticipate any material losses as a result of these commitments.

During the normal course of business, various legal claims arise from time to time which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

As a member of the Federal Reserve System, the Bank is required to maintain certain average reserve balances. These reserve balances include usable vault cash and amounts on deposit with the Federal Reserve Bank. For the final weekly reporting period in the years ended December 31, 2013 and 2012, the amount of daily average required balances were approximately \$960 thousand and \$919 thousand, respectively. In addition, the Bank was required to maintain a compensating balance on deposit with a correspondent bank in the amount of \$250 thousand at December 31, 2013 and 2012.

See Note 19 with respect to financial instruments with off-balance-sheet risk.

## NOTE 14. Derivative Instruments and Hedging Activities

## Interest Rate Swaps

The Company uses interest rate swaps to reduce interest rate risk and to manage interest expense. By entering into these agreements, the Company converts floating rate debt into fixed rate debt, or alternatively, converts fixed rate debt into floating rate debt. Interest differentials paid or received under the swap agreements are reflected as adjustments to interest expense. These interest rate swap agreements are derivative instruments that qualify for hedge accounting as discussed in Note 1. 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 counterparty, the risk in these transactions is the cost of replacing the agreements at current market rates.

On December 4, 2008, the Company entered into an interest rate swap agreement related to the outstanding trust preferred capital notes. The swap agreement became effective on December 1, 2008. The notional amount of the interest rate swap was \$7.0 million and has an expiration date of December 1, 2016. Under the terms of the agreement, the Company pays interest quarterly at a fixed rate of 2.85% and receives interest quarterly at a variable rate of three month LIBOR. The variable rate resets on each interest payment date.

The following table summarizes the fair value of derivative instruments at December 31, 2013 and December 31, 2012:

	2013		2012	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
	(dollars in thousands)			
Derivatives designated as hedging instruments under GAAP				
Interest rate swap contracts	Other Liabilities	\$434	Other Liabilities	\$635

The following tables present the effect of the derivative instrument on the Consolidated Balance Sheets at December 31, 2013 and 2012 and the Consolidated Statements of Income for December 31, 2013, 2012, and 2011:

	Year Ended December 31,		
	Amount of Gain (Loss) Recognized in OCI on Derivative	Location of Gain (Loss) Recognized in Income (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income (Ineffective Portion)
Derivatives in GAAP Cash Flow Hedging Relationships			

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	(Effective Portion)			2013	2012	2011
	2013	2012		2013	2012	2011
	(dollars in thousands)			(dollars in thousands)		
Interest rate swap contracts, net of tax	\$ 132	\$(36 )	Not applicable	\$—	\$—	—

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NOTE 15. Transactions with Directors and Officers

The Bank grants loans to and accepts deposits from its directors, principal officers and related parties of such persons during the ordinary course of business. The aggregate balance of loans to directors, principal officers and their related parties was \$11.2 million and \$11.1 million at December 31, 2013 and 2012, respectively. These balances reflect total principal additions of \$6.8 million and total principal payments of \$6.7 million. The aggregate balance of deposits from directors, principal officers and their related parties was \$10.2 million and \$12.8 million at December 31, 2013 and 2012, respectively.

NOTE 16. Capital Requirements

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that the Company and the Bank met all capital adequacy requirements to which they are subject at December 31, 2013 and 2012.

At December 31, 2013, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the tables. There are no conditions or events since the notification that management believes have changed the Bank's category.

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The following table presents the Company's and the Bank's actual capital amounts and ratios at December 31, 2013 and 2012:

	Actual Amount	Ratio	Minimum Capital Requirement Amount	Ratio	Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions Amount	Ratio		
	(dollars in thousands)							
December 31, 2013:								
Total Capital to Risk Weighted Assets								
Consolidated	\$78,426	18.42	% \$34,062	8.00	% N/A			
Bank of Clarke County	\$74,595	17.61	% \$33,879	8.00	% \$42,349	10.00	%	
Tier 1 Capital to Risk Weighted Assets								
Consolidated	\$73,101	17.17	% \$17,031	4.00	% N/A			
Bank of Clarke County	\$69,299	16.36	% \$16,940	4.00	% \$25,409	6.00	%	
Tier 1 Capital to Average Assets								
Consolidated	\$73,101	12.48	% \$23,435	4.00	% N/A			
Bank of Clarke County	\$69,299	11.89	% \$23,313	4.00	% \$29,141	5.00	%	
December 31, 2012:								
Total Capital to Risk Weighted Assets								
Consolidated	\$72,304	17.98	% \$32,171	8.00	% N/A			
Bank of Clarke County	\$66,891	16.74	% \$31,968	8.00	% \$39,960	10.00	%	
Tier 1 Capital to Risk Weighted Assets								
Consolidated	\$67,258	16.73	% \$16,085	4.00	% N/A			
Bank of Clarke County	\$61,876	15.48	% \$15,984	4.00	% \$23,976	6.00	%	
Tier 1 Capital to Average Assets								
Consolidated	\$67,258	11.70	% \$22,990	4.00	% N/A			
Bank of Clarke County	\$61,876	10.86	% \$22,787	4.00	% \$28,484	5.00	%	

NOTE 17. Restrictions On Dividends, Loans and Advances

Federal and state banking regulations place certain restrictions on dividends paid and loans or advances made by the Bank to the Company. The total amount of dividends which may be paid at any date is generally limited to the lesser of the Bank's retained earnings or the three preceding years' undistributed net income of the Bank. Loans or advances are limited to 10% of the Bank's capital stock and surplus on a secured basis. In addition, dividends paid by the Bank to the Company would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements.

At December 31, 2013, the Bank's retained earnings available for the payment of dividends to the Company was \$16.2 million. Accordingly, \$53.5 million of the Company's equity in the net assets of the Bank was restricted at December 31, 2013. Funds available for loans or advances by the Bank to the Company amounted to \$1.1 million at December 31, 2013.

NOTE 18. Dividend Investment Plan



The Company has a Dividend Investment Plan, which allows participants' dividends to purchase additional shares of common stock at 95% of its fair market value on each dividend record date.

**NOTE 19. Financial Instruments with Off-Balance-Sheet Risk**

The Company, through its subsidiary bank, is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, unfunded commitments under lines of credit, and commercial and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2013 and 2012, the following financial instruments were outstanding whose contract amounts represent credit risk:

	2013	2012
	(dollar in thousands)	
Commitments to extend credit	\$ 17,574	\$ 25,086
Unfunded commitments under lines of credit	81,049	68,959
Commercial and standby letters of credit	4,358	5,526

Commitments to extend credit are agreements to lend to a customer as long as the terms offered are acceptable and certain other conditions are met. Commitments generally have fixed expiration dates or other termination clauses. Since these commitments may expire or terminate, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, with regards to these commitments, is based on management's credit evaluation of the customer.

Unfunded commitments under lines of credit are contracts for possible future extensions of credit to existing customers. Unfunded commitments under lines of credit include, but are not limited to, home equity lines of credit, overdraft protection lines of credit, credit cards, and unsecured and secured commercial lines of credit. The terms and conditions of these commitments vary depending on the line of credit's purpose, collateral, and maturity. The amount disclosed above represents total unused lines of credit for which a contract with the Bank has been established.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in granting loans to customers. The Bank holds collateral supporting these commitments if it is deemed necessary. At December 31, 2013, none of the outstanding letters of credit were collateralized.

The Bank has cash accounts in other commercial banks. The amount on deposit in these banks at December 31, 2013 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$1.0 million.

**NOTE 20. Trust Preferred Capital Notes**

In September 2007, Eagle Financial Statutory Trust II (the "Trust II"), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On September 20, 2007, Trust II issued \$7.0 million of trust preferred securities and \$217 thousand in common equity. The principal asset of Trust II is \$7.2 million of the Company's junior subordinated debt securities with the same maturity and interest rate structures as the capital securities. The securities have a LIBOR-indexed floating rate of interest and the interest rate at December 31, 2013 was 1.86%. The securities have a mandatory redemption date of September 1, 2037, and were subject to varying call provisions beginning September 1, 2012.

The trust preferred securities are included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At December 31, 2013, the total amount (\$7.0 million) of trust preferred securities issued by Trust II is included in the Company's Tier 1 capital.

The obligations of the Company with respect to the issuance of the capital securities constitute a full and unconditional guarantee by the Company of the Trust's obligations with respect to the capital securities.

Subject to certain exceptions and limitations, the Company may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related capital securities.

## NOTE 21. Quarterly Condensed Statements of Income - Unaudited

The Company's quarterly net income, net income per common share and dividends per common share during 2013 and 2012 are summarized as follows:

	2013 Quarter Ended			
	March 31	June 30	September 30	December 31
	(in thousands, except per share amounts)			
Total interest and dividend income	\$6,278	\$6,223	\$6,294	\$6,241
Net interest income after provision for loan losses	5,192	5,199	5,667	6,393
Noninterest income	1,932	2,469	1,581	1,480
Noninterest expenses	4,583	4,952	5,172	5,660
Income before income taxes	2,541	2,716	2,076	2,213
Net income	1,803	2,001	1,505	1,849
Net income per common share, basic	0.54	0.59	0.44	0.54
Net income per common share, diluted	0.53	0.59	0.44	0.54
Dividends per common share	0.19	0.19	0.19	0.19
	2012 Quarter Ended			
	March 31	June 30	September 30	December 31
	(in thousands, except per share amounts)			
Total interest and dividend income	\$6,739	\$6,762	\$6,586	\$6,479
Net interest income after provision for loan losses	5,527	5,624	4,716	5,655
Noninterest income	1,481	1,573	1,553	1,520
Noninterest expenses	4,613	4,380	4,577	4,970
Income before income taxes	2,395	2,817	1,692	2,205
Net income	1,714	2,002	1,253	1,581
Net income per common share, basic	0.52	0.60	0.38	0.47
Net income per common share, diluted	0.52	0.60	0.37	0.47
Dividends per common share	0.18	0.18	0.18	0.19

## NOTE 22. Fair Value Measurements

GAAP requires the Company to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

"Fair Value Measurements" defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1      Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2      Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

- Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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The following sections provide a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

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

**Interest Rate Swap:** The fair value is estimated by a third party using inputs that are observable or that can be corroborated by observable market data, and therefore, is classified within Level 2 of the valuation hierarchy.

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The following table presents balances of financial assets and liabilities measured at fair value on a recurring basis at December 31, 2013 and December 31, 2012:

	Balance as of	Fair Value Measurements at		
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	December 31, 2013 (in thousands)	(Level 1)	(Level 2)	(Level 3)
<b>Assets:</b>				
Securities available for sale				
Obligations of U.S. government corporations and agencies	\$34,744	\$—	\$34,744	\$—
Mortgage-backed securities	15,197	—	15,197	—
Obligations of states and political subdivisions	43,116	—	43,116	—
Corporate securities	8,423	—	8,423	—
Equity securities:				
Bank preferred stock	1,118	1,118	—	—
Total assets at fair value	\$102,598	\$1,118	\$101,480	\$—
<b>Liabilities:</b>				
Interest rate swap	434	—	434	—
Total liabilities at fair value	\$434	\$—	\$434	\$—
	Balance as of	Fair Value Measurements at		
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	December 31, 2012 (in thousands)	(Level 1)	(Level 2)	(Level 3)
<b>Assets:</b>				
Securities available for sale				
Obligations of U.S. government corporations and agencies	\$23,692	\$—	\$23,692	\$—
Mortgage-backed securities	22,207	—	22,207	—
Obligations of states and political subdivisions	43,501	—	43,501	—
Corporate securities	11,156	—	11,156	—
Equity securities:				

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Bank preferred stock	2,198	2,198	—	—
Total assets at fair value	\$102,754	\$2,198	\$100,556	\$—
Liabilities:				
Interest rate swap	635	—	635	—
Total liabilities at fair value	\$635	\$—	\$635	\$—

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

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

**Impaired Loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. Level 2 impaired loan value is determined by utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Level 3 impaired loan values are determined using inventory and accounts receivables collateral and are based on financial statement balances or aging reports. If the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old or has been discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business, then the fair value is considered 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:** Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lesser of the fair value of the property, less estimated selling costs or the loan balance outstanding at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell. Any subsequent valuation adjustments are applied to earnings in the consolidated statements of income. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of GAAP.

The following table displays quantitative information about Level 3 Fair Value Measurements for certain financial assets measured at fair value on a nonrecurring basis for December 31, 2013:

Quantitative information about Level 3 Fair Value Measurements for December 31, 2013				
	Valuation Technique(s)	Unobservable Input	Range	Weighted Average
Assets:				
Impaired loans	Discounted appraised value	Selling cost	12% - 42%	16%
Other real estate owned	Discounted appraised value	Selling cost	5% - 7%	7%



The following table summarizes the Company's financial and nonfinancial assets that were measured at fair value on a nonrecurring basis at December 31, 2013 and December 31, 2012:

	Balance as of December 31, 2013 (in thousands)	Carrying value at December 31, 2013		
		Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Financial Assets:				
Impaired loans	\$2,706	\$—	\$1,299	\$1,407
Nonfinancial Assets:				
Other real estate owned	1,646	638	1,008	—
	Balance as of December 31, 2012 (in thousands)	Carrying value at December 31, 2012		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:				
Impaired loans	\$3,176	\$—	\$1,855	\$1,321
Nonfinancial Assets:				
Other real estate owned	2,928	—	2,320	608

The changes in Level 3 financial assets measured at estimated fair value on a nonrecurring basis during the twelve months ended December 31, 2013 were as follows:

	Fair Value Measurements at December 31, 2013	
	Impaired Loans (in thousands)	Other Real Estate Owned
Balance - January 1, 2013	\$1,321	\$608
Sales proceeds	—	—
Valuation allowance	—	—
(Loss) on disposition	—	—
Transfers into Level 3	3,082	36
Transfers out of Level 3	(2,996	) (644
Total assets at fair value	\$1,407	\$—

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 instrument. 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 the Company's financial instruments:

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Cash and short-term investments/restricted investments/accrued interest: The fair value was equal to the carrying amount.

Securities: The fair value, excluding restricted securities, was based on quoted market prices. The fair value of restricted securities approximated the carrying amount based on the redemption provisions of the issuers.

Loans: The fair value of variable rate loans, which reprice frequently and with no significant change in credit risk, was equal to the carrying amount. The fair value of all other loans was determined using discounted cash flow analysis. The discount rate was equal to the current interest rate on similar products.

Deposits and borrowings: The fair value of demand deposits, savings accounts, and certain money market deposits was equal to the carrying amount. The fair value of all other deposits and borrowings was determined using discounted cash flow analysis. The discount rate was equal to the current interest rate on similar products.

Off-balance-sheet financial instruments: The fair value of commitments to extend credit was estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the credit worthiness of the counterparties. The fair value of fixed rate loan commitments also considered the difference between current interest rates and the committed interest rates. The fair value of standby letters of credit was estimated using the fees currently charged for similar agreements or on the estimated cost to terminate or otherwise settle the obligations with the counterparties.

The carrying amount and fair value of the Company's financial instruments at December 31, 2013 and 2012 were as follows:

	Fair Value Measurements at December 31, 2013				
	Using	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value as of December 31, 2013
	Carrying Value as of December 31, 2013 (in thousands)				
<b>Financial Assets:</b>					
Cash and short-term investments	\$ 14,243	\$ 14,243	\$—	\$—	\$ 14,243
Securities	102,598	1,118	101,480	—	102,598
Restricted Investments	2,192	—	2,192	—	2,192
Loans, net	438,785	—	446,329	1,407	447,736
Accrued interest receivable	1,797	—	1,797	—	1,797
<b>Financial Liabilities:</b>					
Deposits	\$ 487,587	\$—	\$ 488,074	\$—	\$ 488,074
Federal funds purchased and securities sold under agreements to repurchase	—	—	—	—	—
Federal Home Loan Bank advances	22,250	—	22,214	—	22,214
Trust preferred capital notes	7,217	—	7,217	—	7,217
Accrued interest payable	165	—	165	—	165
Interest rate swap contract	434	—	434	—	434



Fair Value Measurements at  
December 31, 2012  
Using

	Carrying Value as of	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value as of December 31, 2012
	December 31, 2012 (in thousands)				
Financial assets:					
Cash and short-term investments	\$48,690	\$48,690	\$—	\$—	\$48,690
Securities	102,754	2,198	100,556	—	102,754
Restricted Investments	2,777	—	2,777	—	2,777
Loans, net	411,520	—	423,367	1,321	424,688
Accrued interest receivable	1,899	—	1,899	—	1,899
Financial liabilities:					
Deposits	\$477,101	\$—	\$478,294	\$—	\$478,294
Federal funds purchased and securities sold under agreements to repurchase	10,000	—	10,042	—	10,042
Federal Home Loan Bank advances	32,250	—	33,188	—	33,188
Trust preferred capital notes	7,217	—	7,217	—	7,217
Accrued interest payable	285	—	285	—	285
Interest rate swap contract	635	—	635	—	635

The Company assumes interest rate risk (the risk that general interest rate levels will change) during its normal operations. As a result, the fair value 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 in order to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay their principal balance in a rising rate environment and more likely to do so in a falling rate environment. Conversely, depositors who are receiving fixed rate interest payments 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 the terms of new loans and deposits and by investing in securities with terms that mitigate the Company's overall interest rate risk.

## NOTE 23. Change in Accumulated Other Comprehensive Income

Accumulated other comprehensive income includes unrealized gains and losses on available for sale securities, change in fair value of interest rate swaps and changes in benefit obligations and plan assets for the post retirement benefit plan. Changes to other comprehensive income are presented net of tax effect as a component of equity.

Reclassifications out of accumulated other comprehensive income are recorded in the Consolidated Statements of Income either as a gain or loss.

Changes to accumulated other comprehensive income by components are shown in the following tables for the years ended December 31, 2013, 2012, and 2011:

	Twelve Months Ended											
	December 31, 2013				2012				2011			
	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total
	(dollars in thousands)											
January 1	\$3,822	\$(418)	\$44	\$3,448	\$3,262	\$(382)	\$51	\$2,931	\$1,545	\$(111)	\$(224)	\$1,210
Other comprehensive (loss) income before reclassifications	(4,497)	201	—	(4,296)	894	(55)	(11)	828	2,669	(411)	421	2,679
Reclassifications from other comprehensive (loss) income	(465)	—	—	(465)	(45)	—	—	(45)	(67)	—	—	(67)
Tax effect of current period changes	1,687	(69)	—	1,618	(289)	19	4	(266)	(885)	140	(146)	(891)
Current period changes net of taxes	(3,275)	132	—	(3,143)	560	(36)	(7)	517	1,717	(271)	275	1,721
December 31	\$547	\$(286)	\$44	\$305	\$3,822	\$(418)	\$44	\$3,448	\$3,262	\$(382)	\$51	\$2,931

For the years ended December 31, 2013, 2012, and 2011, \$465 thousand, \$45 thousand, and \$67 thousand respectively, was reclassified out of comprehensive income and appeared as Gain on Sale of Securities in the Consolidated Statement of Income.



NOTE 24. Subsequent Events

The Company has evaluated events and transactions subsequent to December 31, 2013 through the date these financial statements were issued. Based on definitions and requirements of Generally Accepted Accounting Principles for “Subsequent Events”, the Company has identified one event that requires disclosure in the financial statements.

On February 25, 2014, the Company entered into a \$1.8 million contract to purchase land to build its thirteenth retail branch, located in Loudoun County, Virginia.

## NOTE 25. Condensed Financial Information – Parent Company Only

## EAGLE FINANCIAL SERVICES , INC.

(Parent Company Only)

## Balance Sheets

December 31, 2013 and 2012

(dollars in thousands)

	2013	2012
Assets		
Cash held in subsidiary bank	\$419	\$1,488
Due from banks	504	504
Securities available for sale	2,893	3,261
Investment in subsidiaries, at cost, plus undistributed net income	69,692	65,574
Other assets	575	756
Total assets	\$74,083	\$71,583
Liabilities and Shareholders' Equity		
Trust preferred capital notes	\$7,217	\$7,217
Other liabilities	460	660
Total liabilities	\$7,677	\$7,877
Shareholders' Equity		
Preferred stock	\$—	\$—
Common stock	8,482	8,340
Surplus	11,537	10,424
Retained earnings	46,082	41,494
Accumulated other comprehensive income	305	3,448
Total shareholders' equity	\$66,406	\$63,706
Total liabilities and shareholders' equity	\$74,083	\$71,583

## EAGLE FINANCIAL SERVICES , INC.

(Parent Company Only)

Statements of Income

Years Ended December 31, 2013, 2012, and 2011

(dollars in thousands)

	2013	2012	2011
Income			
Dividends from subsidiary bank	\$—	\$800	\$1,600
Interest and dividends on securities available for sale	98	257	313
(Loss) on equity investments	—	—	—
Other income (loss)	40	38	(108 )
Total income	\$138	\$1,095	\$1,805
Expenses			
Interest expense on borrowings	\$317	\$318	\$317
Other operating expenses	221	192	179
Total expenses	\$538	\$510	\$496
(Loss) income before income tax (benefit) and equity in undistributed net income of subsidiary bank	\$(400 )	\$585	\$1,309
Income Tax (Benefit)	(135 )	(75 )	(122 )
(Loss) income before equity in undistributed net income of subsidiary bank	\$(265 )	\$660	\$1,431
Equity in Undistributed Net Income of Subsidiary Bank	7,423	5,890	2,891
Net income	\$7,158	\$6,550	\$4,322
Comprehensive income	\$4,015	\$7,067	\$6,043



EAGLE FINANCIAL SERVICES , INC.  
(Parent Company Only)  
Statements of Cash Flows  
Years Ended December 31, 2013, 2012, and 2011  
(dollars in thousands)

	2013	2012	2011
<b>Cash Flows from Operating Activities</b>			
Net Income	\$7,158	\$6,550	\$4,322
Adjustments to reconcile net income to net cash provided by operating activities			
Loss on securities	—	—	96
Stock-based compensation expense	305	242	166
(Discount accretion) premium amortization on securities	(1	) (1	) (2
Undistributed earnings of subsidiary bank	(7,423	) (5,890	) (2,891
Changes in assets and liabilities:			
Decrease (increase) in other assets	138	30	(91
Increase (decrease) in other liabilities	1	(2	) (4
Net cash provided by operating activities	\$ 178	\$929	\$1,596
<b>Cash Flows from Investing Activities</b>			
Purchases of securities available for sale	\$(1,044	) \$—	\$—
Proceeds from maturities of securities available for sale	1,458	1,945	500
Net cash provided by investing activities	\$414	\$1,945	\$500
<b>Cash Flows from Financing Activities</b>			
Cash dividends paid	\$(1,909	) \$(1,805	) \$(1,764
Issuance of common stock, employee benefit plan	179	107	89
Stock options exercised	69	—	—
Retirement of common stock	—	—	(271
Net cash (used in) financing activities	\$(1,661	) \$(1,698	) \$(1,946
(Decrease) increase in cash	\$(1,069	) \$1,176	\$150
<b>Cash</b>			
Beginning	\$1,992	\$816	\$666
Ending	\$923	\$1,992	\$816



Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure  
None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of December 31, 2013 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

Management is also responsible for establishing and maintaining adequate internal control over the Company's financial reporting (as defined in Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934, as amended). Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, management has conducted an assessment of the design and effectiveness of its internal controls over financial reporting based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

Management maintains a comprehensive system of internal control 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. The system of internal control provides for appropriate division of responsibility and is documented by written policies and procedures that are communicated to employees. Those policies and procedures: 1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and disposition of the assets of the Company, 2) provide reasonable assurance that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors, 3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements. Management recognizes that there are inherent limitations in the effectiveness of any internal control system, including the possibility of human error and the circumvention or overriding of internal controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Changes in conditions will also impact the internal control effectiveness over time. Eagle Financial Services, Inc. and subsidiaries maintains an internal auditing program, under the supervision of the Audit Committee of the Board of Directors, which independently assesses the effectiveness of the system of internal control and recommends possible improvements.

Under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2013, using the Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded as of December 31, 2013, the Company's internal control over financial reporting is adequate and effective and meets the criteria of the Internal Control – Integrated Framework.

Management's assessment did not determine any material weaknesses within the Company's internal control structure. There were no changes in the Company's internal control over financial reporting during the Company's quarter ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

This annual report does not include an attestation report of the company's registered public accounting firm, regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

Item 9B. Other Information

None.

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PART III

Item 10. Directors, Executives Officers and Corporate Governance

The information required by Part III, Item 10. is incorporated herein by reference to the Proxy Statement for the 2014 Annual Meeting of Shareholders to be held May 21, 2014.

Item 11. Executive Compensation

The information required by Part III, Item 11. is incorporated herein by reference to the Proxy Statement for the 2014 Annual Meeting of Shareholders to be held May 21, 2014.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by Part III, Item 12. is incorporated herein by reference to the Proxy Statement for the 2014 Annual Meeting of Shareholders to be held May 21, 2014.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by Part III, Item 13. is incorporated herein by reference to the Proxy Statement for the 2014 Annual Meeting of Shareholders to be held May 21, 2014.

Item 14. Principal Accounting Fees and Services

The information required by Part III, Item 14. is incorporated herein by reference to the Proxy Statement for the 2014 Annual Meeting of Shareholders to be held May 21, 2014.



PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) Financial Statements

The financial statements are filed as part of this Annual Report on Form 10-K within Item 8.

(a)(2) Financial Statement Schedules

All financial statement schedules are omitted since they are not required, or are not applicable, or the required information is given in the financial statements or notes thereto.

(a)(3) Exhibits

The following exhibits, as applicable, are filed with this Form 10-K or incorporated by reference to previous filings.

Exhibit No.	Description
3.1	Articles of Incorporation of the Company, restated in electronic format only as of March 1, 2006 (incorporated herein by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K dated March 1, 2006).
3.2	Bylaws of the Company (incorporated herein by reference to Exhibit 3.2 of the Company's Registration Statement on Form S-4, Registration No. 33-43681).
10.1	Description of Executive Supplemental Income Plan (incorporated by reference to Exhibit 10.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 1996).*
10.2	Amended and Restated Employment Agreement of John R. Milleson (incorporated herein by reference to Exhibit 10.2 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.3	Amended and Restated Employment Agreement of James W. McCarty, Jr. (incorporated herein by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.4	Amended and Restated Employment Agreement of Elizabeth M. Pendleton (incorporated herein by reference to Exhibit 10.4 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.5	Eagle Financial Services, Inc. Stock Incentive Plan (incorporated herein by reference to Exhibit 4.3 of the Company's Registration Statement on Form S-8, Registration No. 333-118319).*
10.6	Amended and Restated Employment Agreement of John E. Hudson (incorporated herein by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.7	Amended and Restated Employment Agreement of Kaley P. Crosen (incorporated herein by reference to Exhibit 10.7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.8	Employment Agreement of Dale L. Fritts (incorporated herein by reference to Exhibit 10.8 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*

10.9 Employment Agreement of Kathleen J. Chappell (incorporated herein by reference to Exhibit 10.9 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013).\*

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- 10.10 Agreement, dated August 23, 2011, by and between Eagle Financial Services, Inc. and Robert C. Boyd (incorporated herein by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).\*
- 10.11 Addendum to the Agreement, dated August 23, 2011, by and between Eagle Financial Services, Inc. and Robert C. Boyd (incorporated herein by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).\*
- 21.1 Subsidiaries of the Company.
- 23.1 Consent of Smith Elliott Kearns & Company, LLC.
- 31.1 Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification by Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following materials from the Eagle Financial Service, Inc. Annual Report on Form 10-K for the year ended December 31, 2013 formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) notes to Consolidated Financial Statements.

\* Management contracts and compensatory plans and arrangements.

(b) See Item 15(a)(3) above.

(c) See Item 15(a)(2) above.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Eagle Financial Services, Inc.

By: /s/ JOHN R. MILLESON  
John R. Milleson  
President and Chief Executive Officer

Date: March 26, 2014

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 26, 2014.

Signature	Title
/s/ JOHN R. MILLESON John R. Milleson	President, Chief Executive Officer, and Director (principal executive officer)
/s/ KATHLEEN J. CHAPPELL Kathleen J. Chappell	Vice President and Chief Financial Officer (principal financial and accounting officer)
/s/ THOMAS T. GILPIN Thomas T. Gilpin	Chairman of the Board and Director
/s/ ROBERT W. SMALLEY, JR. Robert W. Smalley, Jr.	Vice Chairman of the Board and Director
/s/ THOMAS T. BYRD Thomas T. Byrd	Director
/s/ MARY BRUCE GLAIZE Mary Bruce Glaize	Director
/s/ DOUGLAS C. RINKER Douglas C. Rinker	Director
/s/ ROBERT E. SEVILA Robert E. Sevila	Director
/s/ JOHN D. STOKELY, JR. John D. Stokely, Jr.	Director
/s/ JAMES T. VICKERS James T. Vickers	Director
/s/ RANDALL G. VINSON Randall G. Vinson	Director
/s/ JAMES R. WILKINS, JR James R. Wilkins, Jr.	Director

EXHIBIT INDEX

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21.1 Subsidiaries of the Company.

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- \* Management contracts and compensatory plans and arrangements.