

EAGLE FINANCIAL SERVICES INC  
Form 10-Q  
November 14, 2016

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

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

For the quarterly period ended September 30, 2016  
or

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

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

Commission File Number: 0-20146

EAGLE FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Virginia 54-1601306

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer 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)

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

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

The number of shares of the registrant's Common Stock (\$2.50 par value) outstanding as of November 4, 2016 was 3,481,749.



TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements:	
Consolidated Balance Sheets at September 30, 2016 and December 31, 2015	<u>1</u>
Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2016 and 2015	<u>2</u>
Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2016 and 2015	<u>3</u>
Consolidated Statements of Changes in Shareholders' Equity for the Nine Months Ended September 30, 2016 and 2015	<u>4</u>
Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2016 and 2015	<u>5</u>
Notes to Consolidated Financial Statements	<u>7</u>
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>32</u>
Item 3. Quantitative and Qualitative Disclosures about Market Risk	<u>43</u>
Item 4. Controls and Procedures	<u>44</u>

PART II - OTHER INFORMATION

Item 1. Legal Proceedings	<u>44</u>
Item 1A. Risk Factors	<u>44</u>
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	<u>44</u>
Item 3. Defaults Upon Senior Securities	<u>45</u>
Item 4. Mine Safety Disclosures	<u>45</u>
Item 5. Other Information	<u>45</u>
Item 6. Exhibits	<u>45</u>

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## EAGLE FINANCIAL SERVICES, INC.

## Consolidated Balance Sheets

(dollars in thousands, except per share amounts)

	September 30, 2016	December 31, 2015
	(Unaudited)	
Assets		
Cash and due from banks	\$ 9,902	\$ 11,082
Interest-bearing deposits with other institutions	9,384	12,139
Federal funds sold	108	—
Total cash and cash equivalents	19,394	23,221
Securities available for sale, at fair value	105,554	105,823
Restricted investments	1,068	1,896
Loans	514,312	495,573
Allowance for loan losses	(4,658)	(4,959)
Net Loans	509,654	490,614
Bank premises and equipment, net	20,278	20,964
Other real estate owned, net of allowance	863	571
Other assets	11,610	10,183
Total assets	\$ 668,421	\$ 653,272
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest bearing demand deposits	\$ 203,626	\$ 186,133
Savings and interest bearing demand deposits	288,535	272,214
Time deposits	88,862	92,371
Total deposits	\$ 581,023	\$ 550,718
Federal Home Loan Bank advances	—	20,000
Other liabilities	6,691	4,333
Total liabilities	\$ 587,714	\$ 575,051
Commitments and contingencies		
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 and outstanding 2016, 3,486,425 including 19,901 shares of unvested restricted stock; issued and outstanding 2015, 3,517,648 including 14,401 shares of unvested restricted stock	8,666	8,758
Surplus	12,951	13,730
Retained earnings	57,125	54,682
Accumulated other comprehensive income	1,965	1,051
Total shareholders' equity	\$ 80,707	\$ 78,221
Total liabilities and shareholders' equity	\$ 668,421	\$ 653,272
See Notes to Consolidated Financial Statements		



## EAGLE FINANCIAL SERVICES, INC.

Consolidated Statements of Income (Unaudited)

(dollars in thousands, except per share amounts)

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2016	
	2015	2016	2015	2016
Interest and Dividend Income				
Interest and fees on loans	\$5,658	\$5,540	\$17,250	\$16,278
Interest and dividends on securities available for sale:				
Taxable interest income	354	437	1,276	1,219
Interest income exempt from federal income taxes	230	244	695	733
Dividends	22	42	68	75
Interest on deposits with other institutions	15	2	53	19
Total interest and dividend income	\$6,279	\$6,265	\$19,342	\$18,324
Interest Expense				
Interest on deposits	196	185	591	551
Interest on federal funds purchased and securities sold under agreements to repurchase	1	9	1	10
Interest on Federal Home Loan Bank advances	7	69	136	269
Interest on trust preferred capital notes	—	12	—	78
Interest on interest rate swap	38	46	118	137
Total interest expense	\$242	\$321	\$846	\$1,045
Net interest income	\$6,037	\$5,944	\$18,496	\$17,279
(Recovery of) Provision For Loan Losses	(125 )	(410 )	(46 )	23
Net interest income after (recovery of) provision for loan losses	\$6,162	\$6,354	\$18,542	\$17,256
Noninterest Income				
Income from fiduciary activities	\$315	\$319	\$1,023	\$1,103
Service charges on deposit accounts	321	329	901	926
Other service charges and fees	999	919	2,820	2,605
Gain on sale of securities	8	20	94	116
Gain on redemption of trust preferred capital notes	—	2,424	—	2,424
Other operating income (loss)	44	(181 )	222	(71 )
Total noninterest income	\$1,687	\$3,830	\$5,060	\$7,103
Noninterest Expenses				
Salaries and employee benefits	\$3,251	\$3,090	\$9,828	\$9,197
Occupancy expenses	356	394	1,131	1,176
Equipment expenses	361	312	1,026	718
Advertising and marketing expenses	151	155	498	458
Stationery and supplies	68	67	169	179
ATM network fees	242	246	678	595
Other real estate owned expense	50	63	52	83
(Gain) loss on valuation adjustments and sales of other real estate owned	(12 )	(11 )	35	81
FDIC assessment	103	108	307	319
Computer software expense	180	134	447	547
Bank franchise tax	125	131	376	374
Professional fees	266	211	775	714
Cost to terminate operating lease	—	—	—	520

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

Other operating expenses	730	618	1,935	1,746
Total noninterest expenses	\$5,871	\$5,518	\$17,257	\$16,707
Income before income taxes	\$1,978	\$4,666	\$6,345	\$7,652
Income Tax Expense	548	1,377	1,780	2,110
Net income	\$1,430	\$3,289	\$4,565	\$5,542
Earnings Per Share				
Net income per common share, basic	\$0.40	\$0.94	\$1.29	\$1.59
Net income per common share, diluted	\$0.40	\$0.94	\$1.29	\$1.59
See Notes to Consolidated Financial Statements				

2

---

EAGLE FINANCIAL SERVICES, INC.  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)  
 (dollars in thousands)

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Net income	\$1,430	\$3,289	\$4,565	\$5,542
Other comprehensive (loss) income:				
Unrealized (loss) gain on available for sale securities net of reclassification adjustments, net of deferred income tax of (\$40) and \$259 for the three months ended, respectively and \$471 and (\$58) for the nine months ended, respectively	(79 )	503	914	(112 )
Change in fair value of interest rate swap, net of deferred income tax of \$0 and \$81 for the three months ended, respectively and \$0 and \$99 for the nine months ended, respectively	—	156	—	190
Total other comprehensive (loss) income	(79 )	659	914	78
Total comprehensive income	\$1,351	\$3,948	\$5,479	\$5,620
See Notes to Consolidated Financial Statements				



## EAGLE FINANCIAL SERVICES, INC.

## Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(dollars in thousands, except share amounts)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2014	\$ 8,621	\$ 12,618	\$ 50,578	\$ 1,315	\$ 73,132
Net income			5,542		5,542
Other comprehensive income				78	78
Vesting of restricted stock awards, stock incentive plan (9,363 shares)	23	(23 )			—
Income tax benefit on vesting of restricted stock		4			4
Stock-based compensation expense		227			227
Issuance of common stock, dividend investment plan (24,439 shares)	61	490			551
Issuance of common stock, employee benefit plan (7,114 shares)	18	148			166
Dividends declared (\$0.60 per share)			(2,091 )		(2,091 )
Balance, September 30, 2015	\$ 8,723	\$ 13,464	\$ 54,029	\$ 1,393	\$ 77,609
Balance, December 31, 2015	\$ 8,758	\$ 13,730	\$ 54,682	\$ 1,051	78,221
Net income			4,565		4,565
Other comprehensive income				914	914
Vesting of restricted stock awards, stock incentive plan (8,196 shares)	20	(20 )			—
Stock-based compensation expense		220			220
Issuance of common stock, dividend investment plan (21,765 shares)	55	444			499
Issuance of common stock, employee benefit plan (2,420 shares)	6	52			58
Retirement of common stock (69,104 shares)	(173 )	(1,475 )			(1,648 )
Dividends declared (\$0.60 per share)			(2,122 )		(2,122 )
Balance, September 30, 2016	\$ 8,666	\$ 12,951	\$ 57,125	\$ 1,965	\$ 80,707
See Notes to Consolidated Financial Statements					

EAGLE FINANCIAL SERVICES, INC.  
Consolidated Statements of Cash Flows (Unaudited)  
(dollars in thousands)

	Nine Months Ended September 30,	
	2016	2015
Cash Flows from Operating Activities		
Net income	\$4,565	\$5,542
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	698	619
Amortization of intangible and other assets	137	154
(Recovery of) provision for loan losses	(46)	) 23
Provision for other real estate owned	—	53
Loss on valuation adjustments and sales of other real estate owned	35	81
Loss (gain) on the sale and disposal of premises and equipment	10	(5 )
Loss on the sale of repossessed assets	1	—
(Gain) on the sale of securities	(94)	) (116 )
(Gain) on the redemption of trust preferred capital notes	—	(2,424 )
Loss on derecognition of cash flow hedge	—	237
Fair value adjustment on derivative contract	(113)	) (30 )
Stock-based compensation expense	220	227
Premium amortization on securities, net	287	191
Changes in assets and liabilities:		
(Decrease) increase in other assets	(1,922)	) 437
Increase in other liabilities	2,358	6
Net cash provided by operating activities	\$6,136	\$4,995
Cash Flows from Investing Activities		
Proceeds from maturities, calls, and principal payments of securities available for sale	\$20,324	\$10,641
Proceeds from the sale of securities available for sale	6,338	3,424
Purchases of securities available for sale	(25,201)	) (21,327 )
Proceeds from the sale of restricted investments	850	900
Purchases of restricted investments	(22)	) (413 )
Purchases of bank premises and equipment	(132)	) (2,528 )
Proceeds from the sale of other real estate owned	488	856
Proceeds from the sale of bank premises and equipment	—	5
Proceeds from the sale of repossessed assets	1	10
Net (increase) in loans	(19,701)	) (22,074 )
Net cash (used in) investing activities	\$(17,055)	\$(30,506)
Cash Flows from Financing Activities		
Net increase in noninterest bearing demand deposits, savings, and interest bearing demand deposits	\$33,814	\$23,483
Net (decrease) increase in time deposits	(3,509)	) 572
Net (decrease) in Federal Home Loan Bank advances	(20,000)	) (10,000 )
Redemption of trust preferred capital notes	—	(4,793 )
Issuance of common stock, employee benefit plan	58	166
Retirement of common stock	(1,648)	) —
Cash dividends paid	(1,623)	) (1,540 )

Net cash provided by financing activities	\$7,092	\$7,888
---	---------	---------

5

---

EAGLE FINANCIAL SERVICES, INC.  
Consolidated Statements of Cash Flows (Unaudited)  
(continued)

	Nine Months Ended September 30,	
	2016	2015
(Decrease) in cash and cash equivalents	\$ (3,827 )	\$ (17,623 )
Cash and Cash Equivalents		
Beginning	23,221	34,564
Ending	\$ 19,394	\$ 16,941
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$ 869	\$ 1,141
Income taxes	\$ —	\$ 583
Supplemental Schedule of Noncash Investing and Financing Activities:		
Unrealized gain (loss) on securities available for sale	\$ 1,385	\$ (170 )
Change in fair value of interest rate swap	\$ —	\$ 52
Other real estate and repossessed assets acquired in settlement of loans	\$ 707	\$ 739
Issuance of common stock, dividend investment plan	\$ 499	\$ 551

EAGLE FINANCIAL SERVICES, INC.

Notes to Consolidated Financial Statements (Unaudited)

September 30, 2016

NOTE 1. General

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America.

In the opinion of management, the accompanying financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position at September 30, 2016 and December 31, 2015, the results of operations for the three and nine months ended September 30, 2016 and 2015, and cash flows for the nine months ended September 30, 2016 and 2015. The results of operations for the three and nine months ended September 30, 2016 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 (the "2015 Form 10-K").

Eagle Financial Services, Inc. (the "Company") owns 100% of Bank of Clarke County (the "Bank"). The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All significant intercompany accounts and transactions between the Company and the Bank have been eliminated.

Certain amounts in the consolidated financial statements have been reclassified to conform to current year presentations. None of the reclassifications were of a material nature.

NOTE 2. Stock-Based Compensation Plan

During 2014, 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 authorizes the issuance of up to 500,000 shares of common stock.

The Company periodically grants Restricted Stock to its directors and executive officers. 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. In general, outside directors are periodically granted restricted shares which vest over a period of less than 9 months. Beginning during 2006, executive officers were granted restricted shares which vest over a 3 year service period and restricted shares which vest based on meeting annual performance measures over a 1 year period. The Company recognizes compensation expense over the restricted period. As of September 30, 2016, there was \$134 thousand of unrecognized compensation cost related to nonvested restricted stock.

The following table presents Restricted Stock activity for the nine months ended September 30, 2016 and 2015:

Nine Months Ended			
September 30,			
2016		2015	
Shares	Weighted	Shares	Weighted
	Average		Average
	Grant Date		Grant Date

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

		Fair Value		Fair Value
Nonvested, beginning of period	14,401	\$ 22.98	15,151	\$ 22.27
Granted	14,650	23.07	14,650	23.85
Vested	(8,196 )	22.86	(9,363 )	21.80
Forfeited	(954 )	23.00	(1,037 )	23.50
Nonvested, end of period	19,901	23.09	19,401	23.63

7

---

## NOTE 3. 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. Nonvested restricted shares are included in the weighted average number of common shares used to compute basic earnings per share because of dividend participation and voting rights. 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.

The following table shows the weighted average number of shares used in computing earnings per share for the three and nine months ended September 30, 2016 and 2015 and the effect on the weighted average number of shares of dilutive potential common stock. During 2016 and 2015, there were no potentially dilutive securities outstanding.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Weighted average number of common shares outstanding used to calculate basic earnings per share	3,527,725	3,503,412	3,532,893	3,489,388
Effect of dilutive common stock	—	—	—	—
Weighted average number of common shares outstanding used to calculate diluted earnings per share	3,527,725	3,503,412	3,532,893	3,489,388

## NOTE 4. Securities

Amortized costs and fair values of securities available for sale at September 30, 2016 and December 31, 2015 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
September 30, 2016 (in thousands)				
Obligations of U.S. government corporations and agencies	\$29,414	\$ 1,006	\$ (1 )	\$30,419
Mortgage-backed securities	30,870	629	(10 )	31,489
Obligations of states and political subdivisions	42,350	1,325	(29 )	43,646
	\$102,634	\$ 2,960	\$ (40 )	\$105,554
December 31, 2015 (in thousands)				
Obligations of U.S. government corporations and agencies	\$37,348	\$ 475	\$ (158 )	\$37,665
Mortgage-backed securities	28,858	293	(220 )	28,931
Obligations of states and political subdivisions	38,082	1,169	(24 )	39,227
	\$104,288	\$ 1,937	\$ (402 )	\$105,823

During the nine months ended September 30, 2016, the Company received proceeds of \$6.3 million on sales of available for sale securities for a gross gain of \$94 thousand. There were no losses on the sale of available for sale securities during the nine months ended September 30, 2016. During the nine months ended September 30, 2015, the Company sold \$3.4 million of available for sale securities for a gross gain of \$116 thousand. There were no losses on the sale of available for sale securities during the nine months ended September 30, 2015.





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 September 30, 2016 and December 31, 2015 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
September 30, 2016 (in thousands)						
Obligations of U.S. government corporations and agencies	\$999	\$ 1	\$—	\$ —	\$999	\$ 1
Mortgage-backed securities	3,154	10	—	—	3,154	10
Obligations of states and political subdivisions	4,084	29	—	—	4,084	29
	\$8,237	\$ 40	\$—	\$ —	\$8,237	\$ 40
December 31, 2015 (in thousands)						
Obligations of U.S. government corporations and agencies	\$21,296	\$ 143	\$1,985	\$ 15	\$23,281	\$ 158
Mortgage-backed securities	18,563	194	1,105	26	19,668	220
Obligations of states and political subdivisions	3,414	22	497	2	3,911	24
	\$43,273	\$ 359	\$3,587	\$ 43	\$46,860	\$ 402

Gross unrealized losses on available for sale securities included thirteen (13) and forty-five (45) debt securities at September 30, 2016 and December 31, 2015, 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. 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 September 30, 2016 and December 31, 2015 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 were 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 September 30, 2016 and December 31, 2015. 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. 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 \$3.0 million at September 30, 2016 were pledged for various purposes required by law.

9

---

The composition of restricted investments at September 30, 2016 and December 31, 2015 was as follows:

	September 30, 2016	December 31, 2015
	(in thousands)	
Federal Reserve Bank Stock	\$344	\$ 344
Federal Home Loan Bank Stock	584	1,412
Community Bankers' Bank Stock	140	140
	\$1,068	\$ 1,896

NOTE 5. Allowance for Loan Losses

Changes in the allowance for loan losses for the nine months ended September 30, 2016 and 2015 and the year ended December 31, 2015 were as follows:

	Nine Months Ended September 30, 2016	Year Ended December 31, 2015	Nine Months Ended September 30, 2015
	(in thousands)		
Balance, beginning	\$ 4,959	\$ 5,080	\$ 5,080
(Recovery of) provision for loan losses	(46 )	(227 )	23
Recoveries added to the allowance	217	562	499
Loan losses charged to the allowance	(472 )	(456 )	(438 )
Balance, ending	\$ 4,658	\$ 4,959	\$ 5,164

Nonaccrual and past due loans by class at September 30, 2016 and December 31, 2015 were as follows:

	September 30, 2016 (in thousands)			Total Past Due	Current	Total Loans	90 or More Days Past Due Still Accruing	Nonaccrual Loans
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due					
Commercial - Non Real Estate:								
Commercial & Industrial	\$455	\$ —	\$ 300	\$ 755	\$29,419	\$ 30,174	\$ 300	\$ 375
Commercial Real Estate:								
Owner Occupied	94	760	—	854	111,705	112,559	—	1,017
Non-owner occupied	334	—	—	334	87,655	87,989	—	949
Construction and Farmland:								
Residential	50	—	—	50	6,668	6,718	—	—
Commercial	—	—	—	—	31,885	31,885	—	—
Consumer:								
Installment	18	—	7	25	13,439	13,464	—	12
Residential:								
Equity Lines	—	—	—	—	30,302	30,302	—	137
Single family	569	—	4,437	5,006	190,647	195,653	—	4,815
Multifamily	—	—	—	—	3,625	3,625	—	—

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

All Other Loans	—	—	—	—	1,943	1,943	—	—
Total	\$1,520	\$ 760	\$ 4,744	\$ 7,024	\$507,288	\$ 514,312	\$ 300	\$ 7,305

10

---

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

	December 31, 2015 (in thousands)			Total Past Due	Current	Total Loans	90 or More Past Due Still Accruing	Nonaccrual Loans
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due					
Commercial - Non Real Estate:								
Commercial & Industrial	\$1	\$ —	\$ —	\$ 1	\$29,365	\$ 29,366	\$ —	\$ 475
Commercial Real Estate:								
Owner Occupied	623	142	—	765	108,942	109,707	—	1,614
Non-owner occupied	—	55	746	801	64,664	65,465	—	948
Construction and Farmland:								
Residential	50	—	—	50	8,509	8,559	—	—
Commercial	356	72	—	428	32,582	33,010	—	310
Consumer:								
Installment	43	3	—	46	13,484	13,530	—	—
Residential:								
Equity Lines	175	—	—	175	34,246	34,421	—	276
Single family	2,123	209	1,296	3,628	191,602	195,230	307	1,662
Multifamily	—	—	—	—	3,975	3,975	—	—
All Other Loans	—	—	—	—	2,310	2,310	—	—
Total	\$3,371	\$ 481	\$ 2,042	\$ 5,894	\$489,679	\$ 495,573	\$ 307	\$ 5,285

Allowance for loan losses by segment at September 30, 2016 and December 31, 2015 were as follows:

	As of and for the Nine Months Ended September 30, 2016 (in thousands)							
	Construction and Farmland	Residential	Commercial Real Estate	Commercial - Non Real Estate	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$775	\$2,322	\$1,268	\$211	\$109	\$53	\$221	\$4,959
Charge-Offs	—	(424)	—	—	(16)	(32)	—	(472)
Recoveries	44	114	7	9	39	4	—	217
(Recovery of) provision for loan losses	(265)	45	250	(1)	(51)	(17)	(7)	(46)
Ending balance	\$554	\$2,057	\$1,525	\$219	\$81	\$8	\$214	\$4,658
Ending balance:								
Individually evaluated for impairment	\$—	\$348	\$162	\$7	\$—	\$—	\$—	\$517
Ending balance: collectively evaluated for impairment	\$554	\$1,709	\$1,363	\$212	\$81	\$8	\$214	\$4,141
Loans:								
Ending balance	\$38,603	\$229,580	\$200,548	\$30,174	\$13,464	\$1,943	\$—	\$514,312
Ending balance individually evaluated for impairment	\$1,338	\$9,424	\$3,911	\$1,187	\$—	\$—	\$—	\$15,860
	\$37,265	\$220,156	\$196,637	\$28,987	\$13,464	\$1,943	\$—	\$498,452

Ending balance collectively  
evaluated for impairment

11

---

As of and for the Twelve Months Ended  
December 31, 2015  
(in thousands)

	Construction and Farmland	Residential	Commercial Real Estate	Commercial - Non Real Estate	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$951	\$1,977	\$1,347	\$464	\$103	\$42	\$196	\$5,080
Charge-Offs	(166)	(152)	(47)	—	(66)	(25)	—	(456)
Recoveries	75	142	115	181	33	16	—	562
(Recovery of) provision for loan losses	(85)	355	(147)	(434)	39	20	25	(227)
Ending balance	\$775	\$2,322	\$1,268	\$211	\$109	\$53	\$221	\$4,959
Ending balance:								
Individually evaluated for impairment	\$10	\$423	\$141	\$2	\$—	\$—	\$—	\$576
Ending balance: collectively evaluated for impairment	\$765	\$1,899	\$1,127	\$209	\$109	\$53	\$221	\$4,383
Loans:								
Ending balance	\$41,569	\$233,626	\$175,172	\$29,366	\$13,530	\$2,310	\$—	\$495,573
Ending balance individually evaluated for impairment	\$1,392	\$7,209	\$4,555	\$847	\$—	\$—	\$—	\$14,003
Ending balance collectively evaluated for impairment	\$40,177	\$226,417	\$170,617	\$28,519	\$13,530	\$2,310	\$—	\$481,570

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

Impaired loans by class as of and for the periods ended September 30, 2016 and December 31, 2015 were as follows:

	As of and for the Nine Months Ended September 30, 2016 (in thousands)				
	Unpaid Principal Balance	Recorded Investment (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 639	\$ 603	\$ —	\$ 635	\$ 30
Commercial Real Estate:					
Owner Occupied	1,502	1,359	—	1,378	11
Non-owner occupied	1,200	1,085	—	1,098	13
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	1,338	1,341	—	1,366	57
Residential:					
Equity lines	—	—	—	—	—
Single family	7,399	7,299	—	7,373	150
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$12,078	\$ 11,687	\$ —	\$ 11,850	\$ 261
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 596	\$ 589	\$ 7	\$ 626	\$ 17
Commercial Real Estate:					
Owner Occupied	204	204	37	206	7
Non-owner occupied	1,264	1,268	125	1,280	48
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	—	—	—	—	—
Residential:					
Equity lines	460	120	61	123	—
Single family	2,055	2,015	287	2,034	61
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$4,579	\$ 4,196	\$ 517	\$ 4,269	\$ 133
Total:					
Commercial	\$1,235	\$ 1,192	\$ 7	\$ 1,261	\$ 47
Commercial Real Estate	4,170	3,916	162	3,962	79
Construction and Farmland	1,338	1,341	—	1,366	57
Residential	9,914	9,434	348	9,530	211
Other	—	—	—	—	—
Total	\$16,657	\$ 15,883	\$ 517	\$ 16,119	\$ 394

(1) Recorded investment is defined as the summation of the outstanding principal balance, accrued interest, net deferred loan fees or costs, and any partial charge-offs.





As of and for the Twelve Months End

December 31, 2015

(in thousands)

	Unpaid Principal Balance	Recorded Investment (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 747	\$ 534	\$ —	\$ 749	\$ 18
Commercial Real Estate:					
Owner Occupied	2,146	1,964	—	1,999	19
Non-owner occupied	1,174	1,093	—	1,108	15
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	337	310	—	325	—
Residential:					
Equity lines	149	145	—	145	5
Single family	4,407	4,288	—	4,245	126
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$ 8,960	\$ 8,334	\$ —	\$ 8,571	\$ 183
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 313	\$ 313	\$ 2	\$ 328	\$ 15
Commercial Real Estate:					
Owner Occupied	207	208	39	210	10
Non-owner occupied	1,291	1,295	102	1,311	69
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	1,081	1,085	10	1,109	48
Residential:					
Equity lines	551	216	86	221	3
Single family	2,596	2,575	337	2,600	76
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$ 6,039	\$ 5,692	\$ 576	\$ 5,779	\$ 221
Total:					
Commercial	\$ 1,060	\$ 847	\$ 2	\$ 1,077	\$ 33
Commercial Real Estate	4,818	4,560	141	4,628	113
Construction and Farmland	1,418	1,395	10	1,434	48
Residential	7,703	7,224	423	7,211	210
Other	—	—	—	—	—
Total	\$ 14,999	\$ 14,026	\$ 576	\$ 14,350	\$ 404

(1) Recorded investment is defined as the summation of the outstanding principal balance, accrued interest, net deferred loan fees or costs, and any partial charge-offs.

The average recorded investment for impaired loans for the three months ended September 30, 2016 was \$16.0 million. The interest income recognized on impaired loans for the three months ended September 30, 2016 was \$113 thousand.



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 history of profits, cash flow ability and liquidity. Sufficient cash flow exists to service the loan. All obligations have been paid by the borrower in an as agreed manner.   |
| Pass Monitored  | Pass monitored loans may be experiencing income and cash volatility, inconsistent operating trends, nominal liquidity and/or a 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 negative trends and potential weakness that, if left uncorrected, may negatively affect the borrower's ability to repay its obligations. The risk of default is not imminent and the borrower still demonstrates sufficient financial strength to service debt.                  |
| Substandard     | Substandard loans exhibit well defined weaknesses resulting in a higher probability of default. The borrowers exhibit adverse financial trends and a diminishing ability or willingness to service debt.   |
| Doubtful        | Doubtful loans exhibit all of the characteristics inherent in substandard loans; however given the severity of weaknesses, the collection of 100% of the principal is unlikely under current conditions.   |
| Loss            | Loss loans are considered uncollectible over a reasonable period of time and of such little value that its continuance as a bankable asset is not warranted.   |

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

Credit quality information by class at September 30, 2016 and December 31, 2015 was as follows:

		As of September 30, 2016 (in thousands)						
INTERNAL RISK RATING GRADES	Pass	Pass Monitored	Special Mention	Substandard	Doubtful	Loss	Total	
Commercial - Non Real Estate:								
Commercial & Industrial	\$25,582	\$ 3,501	\$ 181	\$ 910	\$ —	\$ —	-\$30,174	
Commercial Real Estate:								
Owner Occupied	95,555	13,588	1,646	1,333	437	—	112,559	
Non-owner occupied	52,103	34,556	—	1,330	—	—	87,989	
Construction and Farmland:								
Residential	6,668	50	—	—	—	—	6,718	
Commercial	24,942	6,591	—	352	—	—	31,885	
Residential:								
Equity Lines	29,700	465	—	17	120	—	30,302	
Single family	177,110	10,630	597	7,165	151	—	195,653	
Multifamily	3,625	—	—	—	—	—	3,625	
All other loans	1,943	—	—	—	—	—	1,943	
Total	\$417,228	\$ 69,381	\$ 2,424	\$ 11,107	\$ 708	\$ —	-\$500,848	

	Performing	Nonperforming
Consumer Credit Exposure by Payment Activity	\$ 13,439	\$ 25

		As of December 31, 2015 (in thousands)						
INTERNAL RISK RATING GRADES	Pass	Pass Monitored	Special Mention	Substandard	Doubtful	Loss	Total	
Commercial - Non Real Estate:								
Commercial & Industrial	\$25,375	\$ 3,175	\$ 335	\$ 364	\$ 117	\$ —	-\$29,366	
Commercial Real Estate:								
Owner Occupied	90,230	12,553	4,521	1,416	987	—	109,707	
Non-owner occupied	42,988	21,072	—	1,405	—	—	65,465	
Construction and Farm land:								
Residential	8,559	—	—	—	—	—	8,559	
Commercial	20,391	10,886	1,395	338	—	—	33,010	
Residential:								
Equity Lines	30,267	3,878	—	145	131	—	34,421	
Single family	170,168	19,086	950	4,600	426	—	195,230	
Multifamily	3,975	—	—	—	—	—	3,975	
All other loans	2,265	45	—	—	—	—	2,310	
Total	\$394,218	\$ 70,695	\$ 7,201	\$ 8,268	\$ 1,661	\$ —	-\$482,043	

	Performing	Nonperforming
Consumer Credit Exposure by Payment Activity	\$ 13,484	\$ 46



NOTE 6. 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 Company 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-seven (27) troubled debt restructured loans totaling \$7.7 million at September 30, 2016. At December 31, 2015, there were twenty-four (24) troubled debt restructured loans totaling \$7.5 million. Five loans, totaling \$1.3 million, were in nonaccrual status at September 30, 2016. Two loans, totaling \$526 thousand, were in nonaccrual status at December 31, 2015. There were no outstanding commitments to lend additional amounts to troubled debt restructured borrowers at September 30, 2016 or December 31, 2015.

The following tables and narrative set forth information on the Company's troubled debt restructurings by class of financing receivable occurring during the three and nine months ended September 30, 2016 and September 30, 2015:

		Three Months Ended September 30, 2016 (in thousands)	
		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Residential:			
Single family	2	\$ 160	\$ 129
	2	\$ 160	\$ 129

		Three Months Ended September 30, 2015 (in thousands)	
		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Residential:			
Single family	1	\$ 169	\$ 169
	1	\$ 169	\$ 169

		Nine Months Ended September 30, 2016 (dollars in thousands)	
		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Commercial Real Estate			
Non-owner Occupied	1	\$ 736	\$ 736
Residential:			
Single family	3	256	225
Total	4	\$ 992	\$ 961

		Nine Months Ended September 30, 2015 (in thousands)	
		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Residential:			
Single family	2	\$ 688	\$ 688
Total	2	\$ 688	\$ 688





During the three months ended September 30, 2016, there were two loans restructured by granting concessions to borrowers experiencing financial difficulties. Two residential loans were modified by reducing the payments to be affordable for the borrower.

During the nine months ended September 30, 2016, the Company restructured two additional loans by granting concessions to borrowers experiencing financial difficulties. One residential loan and one commercial real estate loan was modified by extending the amortization period and reducing the interest rate.

During the three months ended September 30, 2015, the Company restructured one loan by granting concessions to borrowers experiencing financial difficulties. One residential loan was modified by changing the amortization period.

During the nine months ended September 30, 2015, the Company restructured one additional residential loan by changing the amortization period and interest rate in order to reduce the monthly payments.

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:

	Nine Months Ended September 30, 2016 (dollars in thousands) Number of Recorded Investment Contracts	
Residential:		
Single family	1	\$ 74
Total	1	\$ 74

	Nine Months Ended September 30, 2015 (dollars in thousands) Number of Recorded Investment Contracts	
Commercial - Non Real Estate:		
Commercial & Industrial	1	\$ 73
Residential:		
Equity lines	1	62
Total	2	\$ 135

There were no payment defaults for loans modified as TDRs within the previous 12 months for the three months ended September 30, 2016 and 2015.

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



## NOTE 7. Deposits

The composition of deposits at September 30, 2016 and December 31, 2015 was as follows:

	September 30, 2016	December 31, 2015
	(in thousands)	
Noninterest bearing demand deposits	\$203,626	\$186,133
Savings and interest bearing demand deposits:		
NOW accounts	\$78,605	\$86,199
Money market accounts	119,313	105,560
Regular savings accounts	90,617	80,455
	\$288,535	\$272,214
Time deposits:		
Balances of less than \$250,000	\$67,942	\$80,444
Balances of \$250,000 and more	20,920	11,927
	\$88,862	\$92,371
	\$581,023	\$550,718

## NOTE 8. Postretirement Benefit Plans

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.

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.

Net periodic benefit costs of the postretirement benefit plan for the three months ended September 30, 2016 and 2015 were \$(1) thousand and zero, respectively. Net periodic benefit costs of the postretirement benefit plan for the nine months ended September 30, 2016 and 2015 were \$(2) thousand and \$(1) thousand, respectively.

## NOTE 9. 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. On July 29, 2015, the pool to which the Company's \$7.0 million in outstanding trust preferred capital notes belonged was liquidated by means of auction. The Company was successful in purchasing the outstanding notes at a price of 65.375% of par or \$4.6 million in cash, resulting in a gain on the redemption. On August 7, 2015, the Trust II was dissolved.



NOTE 10. 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.

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, are classified within Level 2 of the valuation hierarchy.

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

The following table presents balances of financial assets and liabilities measured at fair value on a recurring basis at September 30, 2016 and December 31, 2015:

	Fair Value Measurements at September 30, 2016		
	Balance as of	Using Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)
	September 2016 (in thousands)	(Level 1)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>			
Securities available for sale			
Obligations of U.S. government corporations and agencies	\$30,419	\$ —	\$ 30,419
Mortgage-backed securities	31,489	—	31,489
Obligations of states and political subdivisions	43,646	—	43,024
Total assets at fair value	\$105,554	\$ —	\$ 104,932
<b>Liabilities:</b>			
Interest rate swap	\$36	—	\$ 36
Total liabilities at fair value	\$36	\$ —	\$ 36

	Fair Value Measurements at December 31, 2015		
	Balance as of	Using Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)
	December 2015 (in thousands)	(Level 1)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>			
Securities available for sale			
Obligations of U.S. government corporations and agencies	\$37,665	\$ —	\$ 37,665
Mortgage-backed securities	28,931	—	28,931
Obligations of states and political subdivisions	39,227	—	38,543
Total assets at fair value	\$105,823	\$ —	\$ 105,139
<b>Liabilities:</b>			
Interest rate swap	\$149	—	\$ 149
Total liabilities at fair value	\$149	\$ —	\$ 149

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 when due. The measurement of loss associated with impaired loans can be based on the present value of its expected future cash flows discounted at the loan's coupon rate, or at the loans' observable market price or the fair value of the collateral securing the loans, if they are collateral dependent. 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. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data within the last twelve months (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

**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 estimated selling costs, establishing a new costs basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. 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 obtained 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 fair value less cost to sell. The fair value measurement of real estate held in other real estate owned is assessed in the same manner as impaired loans described above. 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 at September 30, 2016 and December 31, 2015:

Quantitative information about Level 3 Fair Value Measurements for September 30, 2016				
	Valuation Technique(s)	Unobservable Input	Range	Weighted Average
Assets:				
Impaired loans	Discounted appraised value	Selling cost	12%	12%
Impaired loans	Present value of cash flows	Discount rate	4% - 8%	5%
Other real estate owned	Discounted appraised value	Selling cost	2% - 6%	5%
December 31, 2015				
	Valuation Technique(s)	Unobservable Input	Range	Weighted Average
Impaired loans	Discounted appraised value	Selling cost	12%	12%
Impaired loans	Present value of cash flows	Discount rate	3% - 8%	5%
Other real estate owned	Discounted appraised value	Selling cost	2% - 6%	5%



The following table summarizes the Company's financial and nonfinancial assets that were measured at fair value on a nonrecurring basis at September 30, 2016 and December 31, 2015:

Balance as of	Fair Value at		
	September 30, 2016	September 30, 2016	
	Quoted Prices in Significant Active Markets for Identical Assets	Other Observable Inputs	Significant Unobservable Inputs
	(Level 1)	(Level 2)	(Level 3)
September 30, 2016 (in thousands)			
Financial Assets:			
Impaired loans	\$3,669	\$—	—\$ 3,669
Nonfinancial Assets:			
Other real estate owned	863	—	863
Balance as of	Fair Value at		
	December 31, 2015	December 31, 2015	
	Quoted Prices in Significant Active Markets for Identical Assets	Other Observable Inputs	Significant Unobservable Inputs
	(Level 1)	(Level 2)	(Level 3)

GAAP defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than through a forced or liquidation sale for purposes of this disclosure. 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 following methods and assumptions were used to estimate the fair value of the Company's financial instruments:

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.

Bank owned life insurance: The carrying amount of bank owned life insurance was a reasonable estimate of fair value.

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 value and fair value of the Company's financial instruments at September 30, 2016 and December 31, 2015 were as follows:

	Fair Value Measurements at September 30, 2016 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	
September 30, 2016 (in thousands)	September 30, 2016 (Level 1)	(Level 2)	(Level 3)	September 30, 2016	
<b>Financial Assets:</b>					
Cash and short-term investments	\$ 19,394	\$ 19,394	\$ —	\$ —	—\$ 19,394
Securities	105,554	—	104,932	622	105,554
Restricted Investments	1,068	—	1,068	—	1,068
Loans, net	509,654	—	—	513,783	513,783
Bank owned life insurance	618	—	618	—	618
Accrued interest receivable	1,696	—	1,696	—	1,696
<b>Financial Liabilities:</b>					
Deposits	\$ 581,023	\$ —	\$ 580,943	\$ —	—\$ 580,943
Accrued interest payable	43	—	43	—	43
Interest rate swap contract	36	—	36	—	36

Fair Value Measurements at  
December 31, 2015  
Using

	Carrying Value as of	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value as of
		December 31 2015 (Level 1)	(Level 2)	(Level 3)	December 31, 2015
Financial assets:					
Cash and short-term investments	\$23,221	\$ 23,221	\$ —	\$ —	—\$23,221
Securities	105,823	—	105,139	684	105,823
Restricted Investments	1,896	—	1,896	—	1,896
Loans, net	490,614	—	—	493,804	493,804
Bank owned life insurance	632	—	632	—	632
Accrued interest receivable	1,739	—	1,739	—	1,739
Financial liabilities:					
Deposits	\$550,718	\$ —	\$ 550,509	\$ —	—\$550,509
Federal Home Loan Bank advances	20,000	—	19,992	—	19,992
Accrued interest payable	66	—	66	—	66
Interest rate swap contract	149	—	149	—	149

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 11. 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 below. 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.



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.

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. This agreement was designated as a cash-flow hedge at inception of the contract until the redemption of the trust preferred capital notes on July 29, 2015. As a result of the redemption, the derivative contract is no longer classified as a cash flow hedge and is currently recorded in the balance sheet at its fair value with changes in fair value recorded in Other operating income (loss) in the Consolidated Statements of Income. The balance of the interest rate swap liability was \$237 thousand at the time of the redemption of the Company's trust preferred debt on July 29, 2015. The total amount recorded in accumulated other comprehensive income at that date was reclassified to earnings due to the derecognition of the cash flow hedge.

The following table summarizes the fair value of derivative instruments at September 30, 2016 and December 31, 2015:

	September 30, 2016		December 31, 2015	
	Balance Sheet	Fair Value	Balance Sheet	Fair Value
	Location		Location	
	(dollars in thousands)			

Derivatives not designated as hedging instruments under GAAP

Interest rate swap contracts	Other Liabilities	\$ 36	Other Liabilities	\$ 149
------------------------------	-------------------	-------	-------------------	--------







	Nine Months Ended September 30, 2016			2015			
	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Assets Interest Rate Swap Plan	Change in Benefit Obligations for Total the Post Retirement Benefit Plan	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Assets Interest Rate Swap Plan	Change in Benefit Obligations and Plan Assets for Total the Post Retirement Benefit Plan	
January 1	\$1,012	\$ 39	\$1,051	\$1,466	\$(190)	\$ 39	\$1,315
Other comprehensive income (loss) before reclassifications	1,479	—	1,479	(54)	52	—	(2)
Reclassification adjustments	(94)	—	(94)	(116)	237	—	121
Tax effect of current period changes	(471)	—	(471)	58	(99)	—	(41)
Current period changes net of taxes	914	—	914	(112)	190	—	78
September 30	\$1,926	\$ 39	\$1,965	\$1,354	\$—	\$ 39	\$1,393

For the three and nine months ended September 30, 2016, \$8 thousand and \$94 thousand, respectively, was reclassified out of accumulated other comprehensive income and appeared as Gain on sale of securities in the Consolidated Statements of Income. The tax related to these reclassifications was \$3 thousand and \$32 thousand, respectively, for the three and nine months ended September 30, 2016. For the three and nine months ended September 30, 2015, \$20 thousand and \$116 thousand, respectively, was reclassified out of comprehensive income and appeared as Gain on sale of securities in the Consolidated Statements of Income. The tax related to these reclassifications was \$7 thousand and \$39 thousand, respectively, for the three and nine months ended September 30, 2015. The tax is included in Income Tax Expense in the Consolidated Statements of Income.

For the three and nine months ended September 30, 2015, \$237 thousand was reclassified out of accumulated other comprehensive income related to the Company's derecognition of its cash flow hedge. This loss was recorded in Other operating income (loss) in the Consolidated Statements of Income. Tax related to this reclassification was \$81 thousand and was included in Income Tax Expense in the Consolidated Statements of Income. There were no reclassifications related to cash flow hedges during the three and nine months ended September 30, 2016.

#### NOTE 13. Recent Accounting Pronouncements

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern". This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have a material impact on

its consolidated financial statements.

29

---

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements. During March 2016, the FASB issued ASU No. 2016-05, "Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships." The amendments in this ASU clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria remain intact. The amendments are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-05 to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, "Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting." The amendments in this ASU eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. In addition, the amendments in this ASU require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after

December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

During March 2016, the FASB issued ASU No. 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Shares-Based Payment Accounting." The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently assessing the impact that ASU 2016-09 will have on its consolidated financial statements.

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

During August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments”, to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

#### NOTE 14. Other Real Estate Owned

The following table is a summary of other real estate owned (OREO) activity for the nine months ended September 30, 2016 and 2015 and the year ended December 31, 2015:

	Nine Months Ended		Nine Months Ended	
	September 30, 2016	December 31, 2015	September 30, 2015	
	(in thousands)			
Balance, beginning	\$571	\$ 2,102	\$ 2,102	
Net loans transferred to OREO	701	867	736	
Sales	(409 )	(2,110 )	(937 )	)
Valuation adjustments	—	(288 )	(53 )	)
Balance, ending	\$863	\$ 571	\$ 1,848	

The major classifications of other real estate owned in the consolidated balance sheets at September 30, 2016 and December 31, 2015 were as follows:

	As of	
	September 30, 2016	December 31, 2015
	(in thousands)	
Construction and Farmland	\$162	\$ 806
Residential Real Estate	701	—
Commercial Real Estate	—	—

Subtotal	\$863	\$ 806
Less valuation allowance	—	235
Total	\$863	\$ 571

There were no consumer mortgage loans collateralized by residential real estate in the process of foreclosure at September 30, 2016 and no consumer mortgage loans collateralized by residential real estate in the process of foreclosure at December 31, 2015.



Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The purpose of this discussion is to focus on the important factors affecting the Company's financial condition, results of operations, liquidity and capital resources. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and the Notes to the Consolidated Financial Statements presented in Part I, Item 1, Financial Statements, of this Form 10-Q and Item 8, Financial Statements and Supplementary Data, of the 2015 Form 10-K.

GENERAL

Eagle Financial Services, Inc. is a bank holding company which owns 100% of the stock of Bank of Clarke County (the "Bank" and collectively with Eagle Financial Services, Inc., the "Company"). 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 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 September 30, 2016, the Company had total assets of \$668.4 million, net loans of \$509.7 million, total deposits of \$581.0 million, and shareholders' equity of \$80.7 million. The Company's net income was \$4.6 million for the nine months ended September 30, 2016.

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 its 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 its trust department, sales of investments through Eagle Investment Services, mortgage originations and deposit operations. The Bank also incurs noninterest expenses such as 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 \$1.0 million on a secured basis and \$500 thousand 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 thousand on a secured basis and \$250 thousand unsecured. Loan exposures up to \$1.0 million may be approved with the concurrence of two, Category I officers. Loans to borrowers with total credit exposures between \$1.0 million and \$3.0 million 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 million 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 quorum). 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 construction project. 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 probable losses inherent 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, including impairment losses 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 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 estimated 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 reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating general and specific losses in the portfolio. As specific loans are identified or losses are experienced on these loans, they will be reflected within the general or specific allowances. Note 1 to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Data, of the 2015 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:

- 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 or if the Bank is unable to successfully integrate these growth opportunities into its existing operations;
- 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," in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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 the nine months ended September 30, 2016 was \$4.6 million, a decrease of \$977 thousand or 17.63% as compared to net income for the nine months ended September 30, 2015 of \$5.5 million. Earnings per share, basic and diluted, were \$1.29 and \$1.59 for the nine months ended September 30, 2016 and 2015, respectively. Net income during the third quarter of 2016 was \$1.4 million, a decrease of \$1.9 million or 56.52% as compared to net income during the third quarter of 2015 of \$3.3 million. Earnings per share, basic and diluted were \$0.40 and \$0.94 for the third quarter of 2016 and 2015, 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, for the nine months ended September 30, 2016 and 2015 was 0.92% and 1.19%, 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 shareholders. The ROE of the Company, on an annualized basis, for the nine months ended September 30, 2016 and 2015 was 7.63% and 9.95%, respectively.

### Net Interest Income

Net interest income is our primary source of revenue, representing the difference between interest and fees earned on interest-earning assets and the interest paid on deposits and other interest-bearing liabilities. The level of net interest income is impacted primarily by variations in the volume and mix of these assets and liabilities, as well as changes in interest rates. Net interest income was \$18.5 million and \$17.3 million for the nine months ended September 30, 2016 and 2015, respectively, which represents an increase of \$1.2 million or 7.04%. Net interest income was \$6.0 million and \$5.9 million for the three months ended September 30, 2016 and 2015, respectively, which represents an increase of \$93 thousand or 1.56%. Increases in net interest income were primarily driven by loan growth and partially offset by decreases in yields. Average interest earning assets increased \$29.6 million from the three months ended September 30, 2015 when compared to the three months ended September 30, 2016 while the average yield decreased by 19 basis points over that same period. Average interest earning assets increased \$39.3 million when comparing the nine months ended September 30, 2015 to the nine months ended September 30, 2016 while the average yield decreased by eight basis points over that same period.

Total interest income was \$19.3 million and \$18.3 million for the nine months ended September 30, 2016 and 2015, respectively, which represents an increase of \$1.0 million or 5.56%. Total interest income was \$6.3 million for the three months ended September 30, 2016 and 2015. Total interest expense was \$846 thousand and \$1.0 million for the nine months ended September 30, 2016 and 2015, respectively, which represents a decrease of \$199 thousand or 19.04%. Total interest expense was \$242 thousand and \$321 thousand for the three months ended September 30, 2016 and 2015, respectively, which represents a decrease of \$79 thousand or 24.61%. The decrease in interest expense is attributable to decreases in average balances off federal funds purchased and FHLB advances. The redemption of trust preferred debt during the third quarter of 2015 was also a big contributor to the decrease in interest expense year over year.

The net interest margin was 4.09% for the nine months ended September 30, 2016 and 2015. 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 2016 and 2015. The following table reconciles tax-equivalent net interest income, which is not a measurement under accounting principles generally accepted in the United States of America (GAAP), to net interest income.

Net interest income and net interest margin may experience some decline as higher yielding assets are repriced or replaced at lower current market rates. More decline is likely occur in the net interest margin than in the cost of funds due to the low level of interest rates currently being paid on interest bearing liabilities.

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015

(in thousands) (in thousands)

## GAAP Financial Measurements:

Interest Income - Loans	\$5,658	\$5,540	\$17,250	\$16,278
Interest Income - Securities and Other Interest-Earnings Assets	621	725	2,092	2,046
Interest Expense - Deposits	196	185	591	551
Interest Expense - Interest Rate Swap	38	46	118	137
Interest Expense - Other Borrowings	8	90	137	357
Total Net Interest Income	\$6,037	\$5,944	\$18,496	\$17,279

## Non-GAAP Financial Measurements:

Add: Tax Benefit on Tax-Exempt Interest Income - Loans (1)	\$28	\$29	\$86	\$90
Add: Tax Benefit on Tax-Exempt Interest Income - Securities (1)	119	126	358	378
Total Tax Benefit on Tax-Exempt Interest Income	\$147	\$155	\$444	\$468
Add: Interest Expense - Interest Rate Swap (2)	38	30	118	30
Tax-Equivalent Net Interest Income	\$6,222	\$6,129	\$19,058	\$17,777

(1) Tax benefit was calculated using the federal statutory tax rate of 34%.

(2) Tax-Equivalent net interest income was adjusted to exclude interest expense related to the interest rate swap incurred after the redemption of the trust preferred capital notes in 2015.

The tax-equivalent yield on earning assets decreased from 4.33% to 4.25% for the nine months ended September 30, 2015 and 2016, respectively. During that same time, the tax-equivalent yield on securities decreased 20 basis points from 3.27% to 3.07%. The tax equivalent yield on loans decreased five basis points from 4.61% for the nine months ended September 30, 2015 to 4.56% for the same time period in 2016. During that same time, the yield on interest-bearing deposits in other banks increased 26 basis points from 0.21% to 0.47%. The decrease in the tax-equivalent yield on loans and securities was the main driver behind the decrease in tax-equivalent yield on earning assets. There were no significant changes in asset mix during the nine months ended September 30, 2016.

The average rate on interest bearing liabilities decreased 12 basis points from 0.37% for the nine months ended September 30, 2015 to 0.25% for the same time period in 2016. The average rate on interest bearing deposits stayed stable at 0.21% during that same time. The Company borrows from the FHLB in the form of short and long term advances. The average rate on FHLB advances decreased 12 basis points from 1.41% to 1.29% for the nine months ended September 30, 2015 and 2016. The Company redeemed its trust preferred debt during the third quarter of 2015. The average rate on trust preferred capital notes was 6.36% for the nine months ended September 30, 2015.

## 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 allowance represents an amount that, in management's judgment, will be adequate to absorb probable losses inherent in the loan portfolio. Management's judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective because it requires estimates that are susceptible to significant revision as more information becomes available. The

amount of provision for loan losses is affected by several factors including the growth rate of loans, net charge-offs, and the estimated amount of potential losses within the loan portfolio. The (recovery of) provision for loan losses was \$(46) thousand and \$23 thousand for the nine months ended September 30, 2016 and 2015, respectively. The (recovery of) loan losses for the nine months ended September 30, 2016 is mainly reflective of the decline in the historic loss estimate component of the general allocation.

## Noninterest Income

Total noninterest income for the nine months ended September 30, 2016 and 2015 was \$5.1 million and \$7.1 million, respectively, which represents a decrease of \$2.0 million or 28.76%. A decrease of \$2.1 million or 55.95% was reflected when comparing the three months ended September 30, 2016 and 2015. Management reviews the activities which generate noninterest income on an ongoing basis.

The following table provides the components of noninterest income for the three and nine months ended September 30, 2016 and 2015, which are included within the respective Consolidated Statements of Income headings. Variances that the Company believes require explanation are discussed below the table.

(dollars in thousands)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Income from fiduciary activities	\$315	\$319	\$(4)	(1)%	\$1,023	\$1,103	\$(80)	(7)%
Service charges on deposit accounts	321	329	(8)	(2)%	901	926	(25)	(3)%
Other service charges and fees	999	919	80	9%	2,820	2,605	215	8%
Gain on sale of securities	8	20	(12)	NM	94	116	(22)	NM
Gain on redemption of trust preferred capital notes	—	2,424	(2,424)	NM	—	2,424	(2,424)	NM
Other operating income	44	(181)	225	(124)%	222	(71)	293	(413)%
Total noninterest income	\$1,687	\$3,830	\$(2,143)	(56)%	\$5,060	\$7,103	\$(2,043)	(29)%

NM - Not Meaningful

Income from fiduciary activities decreased \$80 thousand or 7.25% from \$1.1 million during the nine months ended September 30, 2015 to \$1.0 million during the nine months ended September 30, 2016. 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 2015, the Company collected and recognized into income approximately \$100 thousand of prior year trust fees from one client, causing an increase in income from fiduciary activities. These particular fees were not accrued during prior years due to questions of collectability from the client. Trust fees for this client are now being accrued and billed on a quarterly basis.

Other service charges and fees increased for the three and nine months ended September 30, 2016 when compared to the same period in 2015. The majority of this increase resulted from the increase in fees from ATMs, service release premiums and non-deposit investment sales.

The \$2.4 million gain on redemption of trust preferred capital notes occurred during the third quarter of 2015. On July 29, 2015, the pool to which the Company's \$7.0 million in outstanding trust preferred capital notes belonged was liquidated by means of auction. The Company was successful in purchasing the outstanding notes at a price of 65.375% of par or \$4.6 million in cash, therefore creating a one time gain.

Other operating income increased for the three and nine months ended September 30, 2016 when compared to the same period in 2015. The increase in both periods can be attributed almost solely to the adjustment of the interest rate swap derivative contract to fair value. As previously reported, the Company's cash flow hedge was derecognized upon the retirement of the trust preferred capital notes during the third quarter of 2015. As a result, adjustments of the derivative contract to fair value are now recognized through Other operating income (loss) in the Consolidated Statements of Income.

Noninterest Expenses

Total noninterest expenses increased \$550 thousand or 3.29% from \$16.7 million to \$17.3 million for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2016. Total noninterest expenses increased \$353 thousand or 6.40% for the three months ended September 30, 2015 compared to the same period in 2016. The increase is largely due to the hiring of new employees and the expenses related to branching efforts, which has impacted salaries and employee benefits, occupancy expenses, equipment expenses and advertising and marketing expenses. This increase is partially offset by a \$520 thousand one-time expense resulting from the adjustment to the purchase price of land acquired in June 2015.

The efficiency ratio of the Company was 72.01% and 72.26% for the nine months ended September 30, 2016 and 2015. The efficiency ratio is not a measurement under accounting principles generally accepted in the United States. It is calculated by dividing noninterest expense by the sum of tax equivalent net interest income and noninterest income excluding gains and losses on the investment portfolio. The tax rate utilized is 34%.

The following table presents the components of noninterest expense for the three and nine months ended September 30, 2016 and 2015, which are included within the respective Consolidated Statements of Income headings.

(dollars in thousands)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Salaries and employee benefits	\$3,251	\$3,090	\$ 161	5 %	\$9,828	\$9,197	\$ 631	7 %
Occupancy expenses	356	394	(38)	(10)%	1,131	1,176	(45)	(4)%
Equipment expenses	361	312	49	16 %	1,026	718	308	43 %
Advertising and marketing expenses	151	155	(4)	(3)%	498	458	40	9 %
Stationary and supplies	68	67	1	1 %	169	179	(10)	(6)%
ATM network fees	242	246	(4)	(2)%	678	595	83	14 %
Other real estate owned expense	50	63	(13)	(21)%	52	83	(31)	(37)%
(Gain) loss on valuation adjustments and sales of other real estate owned	(12)	(11)	(1)	NM	35	81	(46)	NM
FDIC assessment	103	108	(5)	(5)%	307	319	(12)	(4)%
Computer software expense	180	134	46	34 %	447	547	(100)	(18)%
Bank franchise tax	125	131	(6)	(5)%	376	374	2	1 %
Professional fees	266	211	55	26 %	775	714	61	9 %
Cost to terminate operating lease	—	—	—	— %	—	520	(520)	(100)%
Other operating expenses	730	618	112	18 %	1,935	1,746	189	11 %
Total noninterest expenses	\$5,871	\$5,518	\$ 353	6 %	\$17,257	\$16,707	\$ 550	3 %

NM - Not Meaningful

Occupancy expenses decreased \$38 thousand or 9.64% during the three months ended September 30, 2016 compared to 2015, despite recent branching efforts in the Loudoun County area. Rental expense has decreased by a net of \$40 thousand during the three months ended September 30, 2016 due to the closure of the Round Hill branch, purchase of the Millbrook branch land and the opening of the East Market Street branch which was formerly operating out of a temporarily rented location, all during 2015.

Equipment expenses increased during the nine months ended September 30, 2016 over 2015 due to several factors. Growth in branches, employees and customer base have caused equipment expenses to increase. In addition, increased regulations to financial institutions have caused a need to incur additional equipment expenses to remain compliant.

ATM network fees increased for the nine months ended September 30, 2016 in comparison to 2015. This increase is due mainly to increased activity from customers which can fluctuate between periods.

Computer software expense decreased during the nine months ended September 30, 2016 over 2015, despite the increase in number of branches and employees. Fees paid to our core software provider have decreased due to a conscious effort to reduce unused services and renegotiate contract amounts. In addition, depreciation related to computer software has decreased due to the decreased volume of computer software related assets being capitalized in

current years related to prior years.

Professional fees during the three months ended September 30, 2016 have increased over the same period in 2015. Approximately \$40 thousand in professional fees were paid during the third quarter of 2016 in order to assist in locating the most qualified replacement for the Senior Loan Officer position.

39

---



Other operating expenses increased for the three and nine months ended September 30, 2016 over 2015. This increase results mostly from the \$136 thousand penalty assess when the Company prepaid its \$20.0 million Federal Home Loan Bank advance in July 2016.

#### Income Taxes

Income tax expense was \$1.8 million and \$2.1 million during the nine months ended September 30, 2016 and 2015, respectively. Income tax expense was \$548 thousand and \$1.4 million during the three months ended September 30, 2016 and 2015. The effective tax rate was 28.05% and 27.57% for the nine months ended September 30, 2016 and 2015, respectively.

### FINANCIAL CONDITION

#### Securities

Total securities available for sale were \$105.6 million at September 30, 2016, compared to \$105.8 million at December 31, 2015. This represents a decrease of \$269 thousand or 0.25%. The Company purchased \$25.2 million in securities during the nine months ended September 30, 2016. The Company had total maturities, calls, and principal repayments of \$20.3 million. There were \$6.3 million in sales during the nine months ended September 30, 2016. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity at September 30, 2016. Note 4 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio at September 30, 2016 and December 31, 2015. The Company had a net unrealized gain on available for sale securities of \$2.9 million at September 30, 2016 as compared to a net unrealized gain of \$1.5 million at December 31, 2015. 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.

#### 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 \$514.3 million and \$495.6 million at September 30, 2016 and December 31, 2015, respectively. This represents an increase of \$18.7 million or 3.78% during the nine months ended September 30, 2016. The ratio of gross loans to deposits decreased only slightly during the nine months ended September 30, 2016 from 89.99% at December 31, 2015 to 88.52% at September 30, 2016 due to comparable amounts of loan and deposit growth.

The loan portfolio consists primarily of loans for owner-occupied single family dwellings, loans secured by commercial real estate, and residential and commercial construction loans. Note 5 to the Consolidated Financial Statements provides the composition of the loan portfolio at September 30, 2016 and December 31, 2015.

Residential real estate loans were \$229.6 million or 44.64% and \$233.6 million or 47.14% of total loans at September 30, 2016 and December 31, 2015, respectively. This represents a decrease of \$4.05 million or 1.73% during the nine months ended September 30, 2016. Commercial real estate loans were \$200.5 million or 38.99% and \$175.2 million or 35.35% of total loans at September 30, 2016 and December 31, 2015, respectively. This represents an increase of \$25.4 million or 14.49% during the nine months ended September 30, 2016. Consumer installment loans were \$13.5 million or 2.62% and \$13.5 million or 2.73% of total loans at September 30, 2016 and December 31, 2015, respectively. Commercial and industrial loans were \$30.2 million or 5.87% and \$29.4 million or 5.93% of total loans at September 30, 2016 and December 31, 2015, respectively.



### Allowance for Loan Losses

The purpose of, and the methods for, measuring the allowance for loan losses are discussed in the Critical Accounting Policies section above. Note 5 to the Consolidated Financial Statements shows the activity within the allowance for loan losses during the nine months ended September 30, 2016 and 2015 and the year ended December 31, 2015. Charged-off loans were \$472 thousand and \$438 thousand for the nine months ended September 30, 2016 and 2015, respectively. Recoveries were \$217 thousand and \$499 thousand for the nine months ended September 30, 2016 and 2015, respectively. This resulted in net (charge-offs) recoveries of \$(255) thousand and \$61 thousand for the nine months ended September 30, 2016 and 2015, respectively. The allowance for loan losses as a percentage of loans was 0.91% at September 30, 2016 and 1.00% at December 31, 2015. The allowance for loan losses was 54.98% of nonperforming assets at September 30, 2016 and 80.46% of nonperforming assets at December 31, 2015. Nonperforming assets increased by \$2.3 million during the nine months ended September 30, 2016 due mainly to the addition of one large loan to nonaccrual status. All nonaccrual and other impaired loans were evaluated for needed specific allocations and were made accordingly. Management believes that the allowance for loan losses is currently adequate to absorb probable losses inherent in the loan portfolio. Given the uncertainty in the economic environment, there is a potential for increases in past due loans, nonperforming loans and other real estate owned. However, the Company believes that the allowance for loan losses will be maintained at a level adequate to mitigate any negative impact resulting from such increases.

### Nonperforming Assets and Other Assets

Nonperforming assets consist of nonaccrual loans, repossessed assets, other real estate owned (foreclosed properties), and loans past due 90 days or more and still accruing. Nonaccrual loans were \$7.3 million and \$5.3 million at September 30, 2016 and December 31, 2015, respectively. The increase in nonaccrual loans during the nine months ended September 30, 2016 was mainly the result of to one large residential real estate loan totaling \$4.1 million being added to nonaccrual status. This increase was partially offset by five loan relationships (seven loans) totaling \$853 thousand being returned to accrual status in accordance with the Bank's loan policy and three nonaccrual loans totaling \$890 thousand being charged-off. during the nine months ended September 30, 2016. Other real estate owned was \$863 thousand at September 30, 2016 and \$571 thousand at December 31, 2015. The Company held four other real estate assets with an average balance of \$216 thousand at September 30, 2016 and \$190 thousand at December 31, 2015. The percentage of nonperforming assets to loans and other real estate owned was 1.64% at September 30, 2016 and 1.18% at December 31, 2015, respectively. There were \$300 thousand in loans past due 90 days or more and still accruing interest at September 30, 2016. Total loans past due 90 days or more and still accruing interest were \$307 thousand at December 31, 2015. The majority of the increase to nonperforming assets, as mentioned above, was due to one large residential real estate loan totaling \$4.1 million and is not necessarily indicative of future trends in nonperforming assets. At September 30, 2016 this loan was rated "Substandard" as defined in Note 5 to the Consolidated Financial Statements, was on nonaccrual status and was classified as an impaired loan. No specific allocation was assigned to this loan due to the fair value (net of selling costs) of the underlying collateral exceeding the Bank's recorded investment in the loan.

During the nine months ended September 30, 2016, the Bank placed ten loans totaling \$4.7 million on nonaccrual status. These loans are secured by real estate. 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.

Loans are placed on nonaccrual 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 fair value of the property based on current appraisals and other current market trends, less estimated selling costs. If a write down of the OREO property is necessary at the time of foreclosure, the amount is charged-off to 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 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. However, restructured loans are not necessarily considered nonperforming assets. At September 30, 2016, the Company had \$7.7 million in restructured loans with specific allowances totaling \$403 thousand. At December 31, 2015, the Company had \$7.5 million in restructured loans with specific allowances totaling \$427 thousand. At September 30, 2016 and December 31, 2015, total restructured loans performing under the restructured terms and accruing interest were \$6.4 million and \$6.9 million, respectively. Five loans, totaling \$1.3 million, were in nonaccrual status at September 30, 2016. Two loans, totaling \$526 thousand, were in nonaccrual status at December 31, 2015.

### Deposits

Total deposits were \$581.0 million and \$550.7 million at September 30, 2016 and December 31, 2015, respectively. This represents an increase of \$30.3 million or 5.50% during the nine months ended September 30, 2016. Note 7 to the Consolidated Financial Statements provides the composition of total deposits at September 30, 2016 and December 31, 2015.

Noninterest-bearing demand deposits which are comprised of checking accounts, increased \$17.5 million or 9.40% from \$186.1 million at December 31, 2015 to \$203.6 million at September 30, 2016. Savings and interest-bearing demand deposits, which include NOW accounts, money market accounts and regular savings accounts increased \$16.3 million or 6.00% from \$272.2 million at December 31, 2015 to \$288.5 million at September 30, 2016. Time deposits decreased \$3.5 million or 3.80% from \$92.4 million at December 31, 2015 to \$88.9 million at September 30, 2016. This is comprised of an increase in time deposits of \$250,000 and more of \$9.0 million or 75.40% and a decrease in time deposits of less than \$250,000 of \$12.5 million or 15.54%. Certificates of deposit also included \$2.5 million and \$12.9 million in brokered certificates of deposit at September 30, 2016 and December 31, 2015, respectively. The Company called \$11.0 million in brokered deposits during the first quarter of 2016.

### CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity at September 30, 2016 was \$80.7 million, reflecting a percentage of total assets of 12.07%, as compared to \$78.2 million and 11.97% at December 31, 2015. During the nine months ended September 30, 2015 and 2016, the Company declared dividends of \$0.60 per share. The Company has a Dividend Investment Plan that reinvests the dividends of the shareholder in Company stock.

The new Basel III rules, effective January 1, 2015, changed the components of regulatory capital and changed the way in which risk ratings are assigned to various categories of bank assets. Also, a new Tier I common risk-based ratio was defined. The new rules resulted in only minor changes to the Company's Tier I and Total risk-based capital, and increased risk-weighted assets due to higher risk weightings for short-term loan commitments and past due and nonaccrual loans. Under the Basel III requirements, at September 30, 2016, the Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions. 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. 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.

In prior years, trust preferred securities, issued by the Company during 2007, qualified as Tier 1 capital because this amount did not exceed 25% of total capital, including the trust preferred securities. Under the changes to the

regulatory capital framework that were approved on July 9, 2013 by the federal banking agencies (Basel III Final Rule), the Company's trust preferred securities continued to be included in Tier 1 capital and total capital, pursuant to a "grandfathering" provision that exempts the Company's securities from the more stringent regulatory capital treatment contained in the Basel III Final Rule for trust preferred securities. As discussed in Note 9 to the Consolidated Financial Statements, the pool to which the Company's \$7.0 million in outstanding trust preferred capital notes belonged was liquidated by means of auction. The Company was successful in purchasing the outstanding notes, which resulted in this amount no longer being outstanding and included in Tier 1 capital beginning in the third quarter of 2015. This transaction did not cause the Company to fall below the well capitalized regulatory minimum.

For capital adequacy purposes, during 2016, financial institutions must maintain a Tier 1 common equity risk-based capital ratio of 4.50%, a Tier 1 risk-based capital ratio of at least 6.00%, a Total risk-based capital ratio of at least 8.00% and a minimum Tier 1 leverage ratio of 4.00%. The Company's policy requires a Tier 1 common equity risk-based capital ratio of 7.00%, a Tier 1 risk-based capital ratio of at least 8.50%, a total risk-based capital ratio of at least 10.50% and a minimum Tier 1 leverage ratio of 6.50%. These are the initial capital requirements, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets. Beginning January 1, 2016, the capital conservation buffer requirement is being phased in at 0.625% of risk-weighted assets, and will increase by the same amount each year until fully implemented at 2.5% on January 1, 2019. The Company's Tier 1 common risk-based capital ratio was 15.02% at September 30, 2016 as compared to 15.22% at December 31, 2015. The Company's Tier 1 risk-based capital ratio was 15.02% at September 30, 2016 as compared to 15.22% at December 31, 2015. The Company's total risk-based capital ratio was 15.91% at September 30, 2016 as compared to 16.20% at December 31, 2015. The Company's Tier 1 capital to average total assets ratio was 11.84% at September 30, 2016 as compared to 12.13% at December 31, 2015. The Company monitors these ratios on a quarterly basis and has several strategies, including without limitation the issuance of common stock, to ensure that these ratios remain above regulatory minimums. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

## 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 September 30, 2016, liquid assets totaled \$216.7 million as compared to \$227.9 million at December 31, 2015. These amounts represent 36.87% and 39.64% of total liabilities at September 30, 2016 and December 31, 2015, respectively. The Company minimizes liquidity demand by utilizing core deposits to fund asset growth. 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. Finally, the Bank's membership with the Federal Home Loan Bank of Atlanta 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.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in Quantitative and Qualitative Disclosures about Market Risk as reported in the 2015 Form 10-K.





Item 4. 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 Quarterly Report on Form 10-Q. 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 September 30, 2016 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). The Company is currently using the 2013 COSO Framework.

There were no changes in the Company's internal control over financial reporting during the Company's quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. 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 1A. Risk Factors

There were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2015.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table details the Company's purchases of its common stock during the third quarter of 2016 pursuant to the Stock Repurchase Program. The Company authorized 150,000 shares for repurchase under the Stock Repurchase program. The Program has an expiration date of June 30, 2017.

Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased	Maximum Number of Shares that may Yet
---	---------------------------------------	---	--

			as Part of Publicly Announced Plan	Be Purchased Under the Plan
July 1 - July 31, 2016	—	\$—	—	150,000
August 1 - August 31, 2016	69,104	23.85	69,104	80,896
September 1 - September 30, 2016	—	—	—	80,896
	69,104	\$ 23.85	69,104	80,896

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are filed with this Form 10-Q and this list includes the exhibit index:

Exhibit No.	Description
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.

The following materials from the Eagle Financial Service, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2016 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.

45

---

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, this 14th day of November, 2016.

Eagle Financial Services, Inc.

By: /S/ JOHN R. MILLESON

John R. Milleson

President and Chief Executive Officer

By: /S/ KATHLEEN J. CHAPPELL

Kathleen J. Chappell

Vice President, Chief Financial Officer

EXHIBIT INDEX

Exhibit  
No. Description

- 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. Quarterly Report on Form 10-Q for the quarter ended September 30, 2016 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.

47