

EAGLE FINANCIAL SERVICES INC  
Form 10-K  
March 29, 2016

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

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

For the fiscal year ended December 31, 2015

Commission File Number: 0-20146

EAGLE FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Virginia

(State or other jurisdiction of  
incorporation or organization)

54-1601306  
(I.R.S. Employer  
Identification No.)

2 East Main Street

P.O. Box 391

Berryville, Virginia

(Address of principal executive offices)

(540) 955-2510

(Registrant's telephone number, including area code)

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

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

Common Stock, Par Value \$2.50

(Title of class)

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

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

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

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

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	(Do not check if a smaller reporting company.)	<input checked="" type="checkbox"/>
		Smaller reporting company	<input type="checkbox"/>

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

The aggregate market value of the voting common equity held by non-affiliates of the registrant at June 30, 2015 was \$64,391,727.

The number of shares of the registrant's Common Stock (\$2.50 par value) outstanding as of March 21, 2016 was 3,535,684.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement for the 2016 Annual Meeting of Shareholders are incorporated by reference into Part III.

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EAGLE FINANCIAL SERVICES, INC.  
INDEX TO FORM 10-K

PART I

Item 1.	Business	<u>4</u>
Item 1A.	Risk Factors	<u>14</u>
Item 1B.	Unresolved Staff Comments	<u>16</u>
Item 2.	Properties	<u>17</u>
Item 3.	Legal Proceedings	<u>17</u>
Item 4.	Mine Safety Disclosures	<u>17</u>

PART II

Item 5.	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	<u>18</u>
Item 6.	Selected Financial Data	<u>20</u>
Item 7.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	<u>21</u>
Item 7A.	Quantitative and Qualitative Disclosures about Market Risk	<u>40</u>
Item 8.	Financial Statements and Supplementary Data	<u>42</u>
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	<u>95</u>
Item 9A.	Controls and Procedures	<u>95</u>
Item 9B.	Other Information	<u>96</u>

PART III

Item 10.	Directors, Executive Officers and Corporate Governance	<u>96</u>
Item 11.	Executive Compensation	<u>96</u>
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	<u>96</u>
Item 13.	Certain Relationships and Related Transactions, and Director Independence	<u>96</u>
Item 14.	Principal Accounting Fees and Services	<u>96</u>

PART IV

Item 15.	Exhibits, Financial Statement Schedules	<u>98</u>
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## PART I

### Item 1. Business

#### General

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

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

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

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

In addition to the Bank, as of December 31, 2014, the Company had a wholly owned subsidiary, Eagle Financial Statutory Trust II, which was formed in connection with the issuance of \$7,000,000 in trust preferred securities in 2007. On August 7, 2015, the Eagle Financial Statutory Trust II was dissolved. The Company’s subsidiary, Bank of Clarke County, is a partner in Bankers Title Shenandoah, LLC, which sells title insurance and is an investor in Virginia Bankers Insurance Center, LLC, which serves as the broker for insurance sales through its member banks. Bank of Clarke County is also an investor in State Theatre Owner, LLC which rehabilitated the State Theatre of Culpeper, Virginia and is an investor in Moore Street Investor, LLC which is rehabilitating two buildings located in Richmond, Virginia.

#### Employees

The Company, including the Bank, had 54 officers, 108 other full-time and 20 part-time employees (or 171 full-time equivalent employees) at December 31, 2015. None of the Company’s employees are represented by a union or covered under a collective bargaining agreement. The Company considers relations with its employees to be excellent.

#### Securities and Exchange Commission Filings

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



### Competition

There is significant competition for both loans and deposits within the Company's trade area. Competition for loans comes from other commercial banks, savings banks, credit unions, mortgage brokers, finance companies, insurance companies, and other institutional lenders. Competition for deposits comes from other commercial banks, savings banks, credit unions, brokerage firms, and other financial institutions. Based on total deposits at June 30, 2015 as reported to the FDIC, the Company has 6.6% of the total deposits in its market area. The Company's market area includes Clarke County, Frederick County, Loudoun County and the City of Winchester.

### Supervision and Regulation

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

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

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

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

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

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

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

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

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

Payment of Dividends. The Company is a legal entity separate and distinct from the Bank. The majority of the Company's revenues are from dividends paid to the Company by the Bank. The Bank is subject to laws and regulations that limit the amount of dividends it can pay. In addition, both the Company and the Bank are subject to various regulatory restrictions relating to the payment of dividends, including requirements to maintain capital at or above regulatory minimums. Banking regulators have indicated that banking organizations should generally pay dividends only if the organization's current earnings are sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition. The Company does not expect that any of these laws, regulations or policies will materially affect the Bank's ability to pay dividends to the Company. Refer to Item 5 for additional information on dividend restrictions. During the year ended December 31, 2015, the Bank paid \$6.6 million in dividends to the Company. The Company paid cash dividends of \$2.1 million to shareholders during 2015.

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

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

Capital Requirements. The Federal Reserve and the other federal banking agencies have issued risk-based and leverage capital guidelines applicable to U.S. banking organizations. Those regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels because of its financial condition or actual or anticipated growth.

On June 7, 2012, the Federal Reserve issued a series of proposed rules intended to revise and strengthen its risk-based and leverage capital requirements and its method for calculating risk-weighted assets. The rules were proposed to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. On July 2, 2013, the Federal Reserve approved certain revisions to the proposals and finalized new capital requirements for banking organizations.

Under the risk-based capital requirements of the Federal Reserve that became effective January 1, 2015, the Company and the Bank are required to maintain a minimum ratio to total capital (which is defined as core capital and supplementary capital less certain specified deductions from total capital such as reciprocal holdings of depository institution capital instruments and equity investments) to risk-weighted assets of at least 8.0% (unchanged from the prior requirement). At least 6% of the total capital is required to be "Tier 1 capital," which consists principally of common and certain qualifying preferred shareholders' equity (including grandfathered trust preferred securities) as well as retained earnings, less certain intangibles and other adjustments (increased from the prior requirement of 4.0%). The "Tier 2 capital" consists of cumulative preferred stock, long-term perpetual preferred stock, a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments), and a limited amount of the general loan loss allowance. A common equity Tier 1 capital ratio of 4.5% of risk-weighted assets was added with the new rules effective January 1, 2015.

Each of the federal bank regulatory agencies also has established a minimum leverage capital ratio of Tier 1 capital to average adjusted assets ("Tier 1 leverage ratio"). The guidelines require a minimum Tier 1 leverage ratio of 3.0% for financial holding companies and banking organizations with the highest supervisory rating. All other banking organizations were required to maintain a minimum Tier 1 leverage ratio of 4.0% unless a different minimum was specified by an appropriate regulatory authority (unchanged from the prior requirement). In addition, for a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its Tier 1 leverage ratio must be at least 5.0%. Banking organizations that have experienced internal growth or made



acquisitions are expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. The Federal Reserve has not advised the Company or the Bank of any specific minimum leverage ratio applicable to either entity.

The capital requirements that became effective January 1, 2015 are the initial capital obligations, 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. The capital conservation buffer requirement is being phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. 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.

With respect to the Bank, the Federal Reserve’s final rules also revised the “prompt corrective action” regulations pursuant to Section 38 of the FDIA by (i) introducing a common equity Tier 1 capital ratio requirement at each level (other than critically undercapitalized), with the required ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum ratio for well-capitalized status being 8.0% (as compared to the prior ratio of 6.0%); and (iii) eliminating the provision that provided that a bank with a composite supervisory rating of 1 may have a 3.0% Tier 1 leverage ratio and still be well-capitalized. These new thresholds were effective for the Bank as of January 1, 2015. The minimum total capital to risk-weighted assets ratio (10.0%) and minimum leverage ratio (5.0%) for well-capitalized status were unchanged by the final rules.

The new capital requirements also include changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development, and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status, a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital, and increased risk-weights (from 0% to up to 600%) for equity exposures.

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

**Interstate Banking and Branching.** Current federal law authorizes interstate acquisitions of banks and bank holding companies without geographic limitation. Effective June 1, 1997, a bank headquartered in one state is authorized to merge with a bank headquartered in another state, as long as neither of the states had opted out of such interstate

merger authority prior to such date. After a bank has established branches in a state through an interstate merger transaction, the bank may establish and acquire additional branches at any location in the state where a bank headquartered in that state could have established or acquired branches under applicable federal or state law.

7

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

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

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

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

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

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

Community Reinvestment Act. Under the Community Reinvestment Act and related regulations, depository institutions have an affirmative obligation to assist in meeting the credit needs of their market areas, including low and moderate-income areas, consistent with safe and sound banking practice. The Community Reinvestment Act directs each bank to maintain a public file containing specific information, including all written comments received from the public for the current year and each of the previous two calendar years that specifically relate to the bank's

performance in helping to meet community credit needs. Depository institutions are periodically examined for compliance with the Community Reinvestment Act and are periodically assigned ratings in this regard. Banking regulators consider a depository institution's Community Reinvestment Act rating when reviewing applications to establish new branches, undertake new lines of business, and/or acquire part or all of another depository institution. An unsatisfactory rating can significantly delay or even prohibit regulatory approval of a proposed transaction by a bank holding company or its depository institution subsidiaries.

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

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

These governmental agencies have clarified what they consider to be lending discrimination and have specified various factors that they will use to determine the existence of lending discrimination under the Equal Credit Opportunity Act and the Fair Housing Act, including evidence that a lender discriminated on a prohibited basis, evidence that a lender treated applicants differently based on prohibited factors in the absence of evidence that the treatment was the result of prejudice or a conscious intention to discriminate, and evidence that a lender applied an otherwise neutral non-discriminatory policy uniformly to all applicants, but the practice had a discriminatory effect, unless the practice could be justified as a business necessity.

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

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

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

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

The GLBA adopts a system of functional regulation under which the Federal Reserve Board is designated as the umbrella regulator for financial holding companies, but financial holding company affiliates are principally regulated by functional regulators such as the FDIC for state nonmember bank affiliates, the Securities and Exchange Commission for securities affiliates, and state insurance regulators for insurance affiliates. It repeals the broad exemption of banks from the definitions of "broker" and "dealer" for purposes of the Securities Exchange Act of 1934, as amended. It also identifies a set of specific activities, including traditional bank trust and fiduciary activities, in which

a bank may engage without being deemed a “broker,” and a set of activities in which a bank may engage without being deemed a “dealer.” Additionally, the new law makes conforming changes in the definitions of “broker” and “dealer” for purposes of the Investment Company Act of 1940, as amended, and the Investment Advisers Act of 1940, as amended.

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

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

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

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

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





Dodd-Frank Act. In July 2010, the Dodd-Frank Act was signed into law, incorporating numerous financial institution regulatory reforms. The Dodd-Frank Act implements far-reaching reforms of major elements of the financial landscape, particularly for larger financial institutions. Many of its provisions do not directly impact community-based institutions like the Bank. For instance, provisions that regulate derivative transactions and limit derivatives trading activity of federally-insured institutions, enhance supervision of “systemically significant” institutions, impose new regulatory authority over hedge funds, limit proprietary trading by banks, and phase-out the eligibility of trust preferred securities for Tier 1 capital are among the provisions that do not directly impact the Bank either because of exemptions for institutions below a certain asset size or because of the nature of the Bank’s operations. Provisions that could impact the Bank include the following:

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

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

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

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

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

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

**Holding Company Capital Levels.** Bank regulators are required to establish minimum capital levels for holding companies that are at least as stringent as those currently applicable to banks. In addition, all trust preferred securities issued after May 19, 2010 will be counted as Tier 2 capital, but the Company’s currently outstanding trust preferred securities will continue to qualify as Tier 1 capital.

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

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

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

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

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

Volcker Rule. The Dodd-Frank Act prohibits insured depository institutions and their holding companies from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of 3% of Tier 1 capital in private equity and hedge funds (known as the “Volcker Rule”). On December 10, 2013, the federal bank regulatory agencies adopted final rules implementing the Volcker Rule. These final rules prohibit banking entities from (i) engaging in short-term proprietary trading for their own accounts, and (ii) having certain ownership interests in and relationships with hedge funds or private equity funds. The final rules are intended to provide greater clarity with respect to both the extent of those primary prohibitions and of the related exemptions and exclusions. The final rules also require each regulated entity to establish an internal compliance program that is consistent with the extent to which it engages in activities covered by the Volcker Rule, which must include (for the largest entities) making regular reports about those activities to regulators. Although the final rules provide some tiering of compliance and reporting obligations based on size, the fundamental prohibitions of the Volcker Rule apply to banking entities of any size, including the Company and the Subsidiary Banks. The final rules are effective April 1, 2014, but the conformance period has been extended from its statutory end date of July 21, 2014 until July 21, 2017. The Company has evaluated the implications of the final rules on its investments and does not expect any material financial implications.

Under the final rules implementing the Volcker Rule, banking entities would have been prohibited from owning certain collateralized debt obligations (“CDOs”) backed by trust preferred securities (“TruPS”) as of July 21, 2017, which could have forced banking entities to recognize unrealized market losses based on the inability to hold any such investments to maturity. However, on January 14, 2014, the federal bank regulatory agencies issued an interim rule, effective April 1, 2014, exempting TruPS CDOs from the Volcker Rule if (i) the CDO was established prior to May 19, 2010, (ii) the banking entity reasonably believes that the offering proceeds of the CDO were used to invest primarily in TruPS issued by banks with less than \$15 billion in assets, and (iii) the banking entity acquired the CDO on or before December 10, 2013. However, regulators are soliciting comments to the Interim Rule, and this exemption could change prior to its effective date. The Company currently does not have any impermissible holdings of TruPS CDOs under the interim rule, and therefore, will not be required to divest of any such investments or change the accounting treatment.

Ability-to-Repay and Qualified Mortgage Rule. Pursuant to the Dodd-Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring creditors to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Creditors are required to determine consumers’ ability to repay in one of two ways. The first alternative requires the creditor to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the creditor can originate “qualified mortgages,” which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a “qualified mortgage” is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are “higher-priced” (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not “higher-priced” (e.g. prime loans) are given a safe harbor of compliance. To meet the mortgage credit needs of a broader customer base, the Company is predominantly an originator of mortgages that are in compliance with the Ability-to-Pay rules.

Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z). Pursuant to the Dodd-Frank Act, the CFPB issued a final rule on November 20, 2013 (effective on October 3, 2015), combining certain disclosures that consumers receive in connection with applying for and closing on a mortgage loan under the Truth in Lending Act and the Real Estate Settlement Procedures Act. The

Bureau amended Regulation X (Real Estate Settlement Procedures Act) and Regulation Z (Truth in Lending) to establish new disclosure requirements and forms in Regulation Z for most closed-end consumer credit transactions secured by real property. In addition to combining the existing disclosure requirements and implementing new requirements imposed by the Dodd-Frank Act, the final rule provides extensive guidance regarding compliance with those requirements. The final rule applies to most closed-end consumer mortgages. It does not apply to home equity lines of credit, reverse mortgages, or mortgages secured by a mobile home or by a dwelling that is not attached to real property (in other words, land). The final rule also does not apply to loans made by a creditor who makes five or fewer mortgages in a year.

**Flood Insurance Rule.** On July 21, 2015, five federal regulatory agencies announced the approval of a joint final rule that modifies regulations that apply to loans secured by properties located in special flood hazard areas. The final rule implements provisions of the Homeowner Flood Insurance Affordability Act of 2014 relating to the escrowing of flood insurance payments and the exemption of certain detached structures from the mandatory flood insurance purchase requirement. The final rule also implements provisions in the Biggert-Waters Act relating to the force placement of flood insurance.

**Home Mortgage Disclosure Act (HMDA) Final Rule.** On October 15, 2015, the CFPB issued the final rule aimed at increasing the “quality and type” of HMDA data collected and reported by financial institutions. The final HMDA rule will expand the types of loans subject to reporting and increase the number of data fields. Lenders will have to collect and report additional information on applicants and borrowers, property used to secure loans, loan features and unique identifiers. The rule adds 25 new data points and amends 14 existing data points.

The most significant changes are not effective until January 1, 2018. On or before March 1, 2019, lenders will report the new data they collect in 2018.

#### Item 1A. Risk Factors

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

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

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

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

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

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

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

Difficult market conditions have adversely affected our industry.

Dramatic declines in the housing market, falling home prices and increasing foreclosures, and unemployment and under-employment have negatively impacted the credit performance of real estate related loans and resulted in significant write-downs of asset values by financial institutions. These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting economic pressure on consumers and lack of confidence in the financial markets has adversely affected our business and results of operations. Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for credit losses, although these conditions have shown signs of stabilization in 2013 and

2014. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial institutions industry.



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

The Company's branches are located in the counties of Clarke, Frederick and Loudoun, the towns of Purcellville, Leesburg and Ashburn, and the City of Winchester. Because our lending is concentrated in this market, we will be affected by the general economic conditions in these areas. Changes in the economy may influence the growth rate of our loans and deposits, the quality of the loan portfolio and loan and deposit pricing. A decline in general economic conditions caused by inflation, recession, unemployment or other factors beyond our control would impact the demand for banking products and services generally, which could negatively affect our financial condition and performance.

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

The Company and the Bank are each subject to capital adequacy guidelines and other regulatory requirements specifying minimum amounts and types of capital which each must maintain. From time to time, regulators implement changes to these regulatory capital adequacy guidelines. Under the Dodd-Frank Act, the federal banking agencies have established stricter capital requirements and leverage limits for banks and bank holding companies that are based on the Basel III regulatory capital reforms. The Basel III Capital Rules require bank holding companies and their subsidiaries, to maintain significantly more capital and adopted more demanding regulatory capital risk weightings and calculations. As a result of the Basel III Capital Rules, many community banks could be forced to limit banking operations and activities, and growth of loan portfolios, in order to focus on retention of earnings to improve capital levels. The Company believes that it maintains sufficient levels of Tier 1 and Common Equity Tier 1 capital to comply with the Basel III Final Rules. However, if the Company and the Bank fail to meet these minimum capital guidelines and/or other regulatory requirements, the Company could be subject to regulatory restrictions, including limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses, or experience other adverse consequences that could cause its financial condition to be materially and adversely affected.

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

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

The Company's concentration in loans secured by real estate may increase its credit losses, which would negatively affect our financial results.

At December 31, 2015, loans secured by real estate totaled \$450.4 million and represented 90.88% of the Company's loan portfolio. If we experience further adverse changes in the local real estate market or in the local or national economy, borrowers' ability to pay these loans may be further impaired, which could impact the Company's financial performance. The Company attempts to limit its exposure to this risk by applying good underwriting practices at origination, evaluating the appraisals used to establish property values, and routinely monitoring the financial condition of borrowers. If the value of real estate serving as collateral for the loan portfolio were to continue to decline materially, a significant part of the loan portfolio could become under-collateralized. If the loans that are secured by real estate become troubled when real estate market conditions are declining or have declined, in the event of foreclosure, the Company may not be able to realize the amount of collateral that was anticipated at the time of

originating the loan. In that event, the Company might have to increase the provision for loan losses, which could have a material adverse effect on its operating results and financial condition.

An inadequate allowance for loan losses would reduce our earnings.

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

- actual loan loss history;
- volume, growth, and composition of the loan portfolio;
- the amount of non-performing loans and the value of their related collateral;
- the effect of changes in the local real estate market on collateral values;
- the effect of current economic conditions on a borrower's ability to pay; and
- other factors deemed relevant by management.

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

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

The soundness of other financial institutions could adversely affect us.

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

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

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

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

The Company believes that its growth and success depends heavily upon the skills of its senior management team.

The Company also depends on the experience of its subsidiary's officers and on their relationships with the customers

they serve. The loss of one or more of these officers could disrupt the Company's operations and impair its ability to implement its business strategy, which could adversely affect the Company's financial condition and performance.

Item 1B. Unresolved Staff Comments

None.

16

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Item 2. Properties

The Company owns or leases buildings which are used in normal business operations. The Company's corporate headquarters, and that of Bank of Clarke County, is located at 2 East Main Street, Berryville, Virginia, 22611. At December 31, 2015, Bank of Clarke County operated twelve full-service branches and one drive-through only facility in the Virginia communities of Berryville, Winchester, Boyce, Stephens City, Purcellville, Leesburg and Ashburn. See Note 1 "Nature of Banking Activities and Significant Accounting Policies" and Note 6 "Bank Premises and Equipment, Net" in the "Notes to the Consolidated Financial Statements" of this Form 10-K for information with respect to the amounts at which bank premises and equipment are carried and commitments under long-term leases. All of the Company's properties are well maintained, are in good operating condition and are adequate for the Company's present and anticipated future needs.

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

None.



## PART II

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

The Company’s common stock trades on the OTC Markets Group’s OTCQX Market under the symbol “EFSI.” The OTC Markets Group provides information about the common stock to professional market makers who match sellers with buyers. Securities brokers can obtain information from the OTC Markets Group when working with clients. When a client decides to initiate a transaction, the broker will contact one of the stock’s market makers.

The Company has a limited record of trades involving its common stock in the sense of “bid” and “ask” prices or in highs and lows. The effort to accurately disclose trading prices is made more difficult due to the fact that price per share information is not required to be disclosed to the Company when shares of its stock have been sold by holders and purchased by others. The table titled “Common Stock Market Price and Dividend Data” summarizes the high and low sales prices of shares of the Company’s common stock on the basis of trades known to the Company (including trades through the OTC Markets Group) and dividends declared during 2015 and 2014. The Company may not be aware of the per share price of all trades made.

## Common Stock Market Price and Dividend Data

	2015		2014		Dividends Per Share	
	High	Low	High	Low	2015	2014
1st Quarter	\$24.50	\$22.85	\$23.45	\$21.29	\$0.20	\$0.19
2nd Quarter	26.25	23.10	23.60	22.40	0.20	0.19
3rd Quarter	24.80	22.90	24.10	22.51	0.20	0.19
4th Quarter	24.00	22.85	24.25	22.51	0.20	0.20

As of March 21, 2016, the Company had approximately 1,039 shareholders of record.

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

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

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

The Federal Reserve and the state of Virginia have the general authority to limit the dividends paid by insured banks if the payment is deemed an unsafe and unsound practice. Both the state of Virginia and the Federal Reserve have indicated that paying dividends that deplete a bank’s capital base to an inadequate level would be an unsound and unsafe banking practice. Under the Federal Reserve’s regulations, the Bank may not declare or pay any dividend in excess of its net income for the current year plus any retained net income from the prior two calendar years. The Bank

may also not declare or pay a dividend without the approval of its board and two-thirds of its shareholders if the dividend would exceed its undivided profits, as reported to the Federal Reserve.



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

#### Stock Performance

The following line graph compares the cumulative total return to the shareholders of the Company to the returns of the NASDAQ Bank Index and the NASDAQ Composite Index for the last five years. The amounts in the table represent the value of the investment on December 31<sup>st</sup> of the year indicated, assuming \$100 was initially invested on December 31, 2009 and the reinvestment of dividends. See Management Discussion and Analysis sections Liquidity and Capital Resources and Note 17, "Restrictions on Dividends, Loans and Advances" to the Consolidated Financial Statements for information on Eagle Financial Services, Inc. ability and intent to pay dividends.

	2010	2011	2012	2013	2014	2015
Eagle Financial Services, Inc.	\$100	\$107	\$145	\$153	\$165	\$168
NASDAQ Bank Index	100	88	101	141	145	154
NASDAQ Composite Index	100	98	114	157	179	189

## Item 6. Selected Financial Data

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

	December 31,					
	2015	2014	2013	2012	2011	
	(dollars in thousands, except per share amounts)					
<b>Income Statement Data:</b>						
Interest and dividend income	\$24,493	\$24,850	\$25,036	\$26,566	\$27,571	
Interest expense	1,347	1,912	2,585	3,384	4,805	
Net interest income	\$23,146	\$22,938	\$22,451	\$23,182	\$22,766	
(Recovery of) provision for loan losses	(227	) 350	—	1,660	3,750	
Net interest income after (recovery of) provision for loan losses	\$23,373	\$22,588	\$22,451	\$21,522	\$19,016	
Noninterest income	8,438	6,606	7,462	6,127	5,946	
Net revenue	\$31,811	\$29,194	\$29,913	\$27,649	\$24,962	
Noninterest expenses	22,481	19,986	20,367	18,540	19,269	
Income before income taxes	\$9,330	\$9,208	\$9,546	\$9,109	\$5,693	
Income tax expense	2,433	2,068	2,388	2,559	1,371	
Net Income	\$6,897	\$7,140	\$7,158	\$6,550	\$4,322	
<b>Performance Ratios:</b>						
Return on average assets	1.10	% 1.19	% 1.23	% 1.15	% 0.76	%
Return on average equity	9.17	% 10.25	% 11.04	% 10.71	% 7.73	%
Shareholders' equity to assets	11.97	% 11.67	% 11.32	% 10.74	% 10.23	%
Dividend payout ratio	40.61	% 37.03	% 36.02	% 37.10	% 54.77	%
Non-performing loans to total loans	1.13	% 2.28	% 1.00	% 0.63	% 0.62	%
Non-performing assets to total assets	0.95	% 2.04	% 1.04	% 0.94	% 0.86	%
<b>Per Common Share Data:</b>						
Net income, basic	\$1.97	\$2.08	\$2.11	\$1.97	\$1.31	
Net income, diluted	1.97	2.08	2.11	1.96	1.31	
Cash dividends declared	0.80	0.77	0.76	0.73	0.72	
Book value	22.25	21.01	19.57	19.11	17.67	
Market price	23.00	23.30	22.50	22.00	16.81	
Average shares outstanding, basic	3,495,334	3,438,348	3,386,467	3,333,235	3,292,290	
Average shares outstanding, diluted	3,495,334	3,438,646	3,387,212	3,343,212	3,299,998	
<b>Balance Sheet Data:</b>						
Total securities	\$107,719	\$96,973	\$104,790	\$105,531	\$117,654	
Total loans	495,573	469,820	444,273	418,097	410,424	
Total assets	653,272	630,158	586,444	593,276	568,022	
Total deposits	550,718	503,816	487,587	477,101	448,465	
Shareholders' equity	78,221	73,132	66,406	63,706	58,090	



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

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

### GENERAL

The Company is a bank holding company which owns 100% of the stock of Bank of Clarke County (the "Bank"). Accordingly, the results of operations for the Company are dependent upon the operations of the Bank. The Bank conducts commercial banking business which consists of attracting deposits from the general public and investing those funds in commercial, consumer and real estate loans and corporate, municipal and U.S. government agency securities. The Bank's deposits are insured by the Federal Deposit Insurance Corporation to the extent permitted by law. At December 31, 2015, the Company had total assets of \$653.3 million, net loans of \$490.6 million, total deposits of \$550.7 million and shareholders' equity of \$78.2 million. The Company's net income was \$6.9 million for the year ended December 31, 2015.

### MANAGEMENT'S STRATEGY

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

### OPERATING STRATEGY

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

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

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

### LENDING POLICIES

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

debt.

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

21

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

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

### Commercial and Industrial Lending

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

### Consumer Lending

The Bank offers various secured and unsecured consumer loans, which include personal installment loans, personal lines of credit, automobile loans, and credit card loans. The Bank originates its consumer loans within its geographic market area and these loans are generally made to customers with whom the Bank has an existing relationship. Consumer loans generally entail greater risk than residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by rapidly depreciable assets such as automobiles. In such cases, any repossessed collateral on a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. Consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

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

### CRITICAL ACCOUNTING POLICIES

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

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



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

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

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

## RESULTS OF OPERATIONS

### Net Income

Net income for 2015 was \$6.9 million, a decrease of \$243 thousand or 3.40% over 2014's net income of \$7.1 million. Net income for 2014 decreased \$18 thousand or 0.25% from 2013's net income of \$7.2 million. Diluted earnings per share were \$1.97, \$2.08, and \$2.11 for 2015, 2014, and 2013, respectively.

Return on average assets (ROA) measures how efficiently the Company uses its assets to produce net income. Some issues reflected within this efficiency include the Company's asset mix, funding sources, pricing, fee generation, and cost control. The ROA of the Company, on an annualized basis, was 1.10%, 1.19%, and 1.23% for 2015, 2014, and 2013, respectively.

Return on average equity (ROE) measures the utilization of shareholders' equity in generating net income. This measurement is affected by the same factors as ROA with consideration to how much of the Company's assets are funded by the shareholders. The ROE for the Company was 9.17%, 10.25%, and 11.04% for 2015, 2014, and 2013, respectively.

### Net Interest Income

Net interest income, the difference between total interest income and total interest expense, is the Company's primary source of earnings. Net interest income was \$23.1 million for 2015, \$22.9 million for 2014, and \$22.5 million for 2013, which represents an increase of \$208 thousand or 0.91% and an increase of \$487 thousand or 2.17% for 2015 and 2014, respectively. Net interest income is derived from the volume of earning assets and the rates earned on those assets as compared to the cost of funds. Total interest income was \$24.5 million for 2015, \$24.9 million for 2014, and \$25.0 million for 2013, which represents a decrease of \$357 thousand or 1.44% and \$186 thousand or 0.74% for 2015 and 2014, respectively. Total interest expense was \$1.3 million for 2015, \$1.9 million for 2014, and \$2.6 million for 2013, which represents a decrease of \$565 thousand or 29.55% and \$673 thousand or 26.03% in 2015 and 2014, respectively. The decreases in total interest income and total interest expense during 2015 are driven mainly by the interest rate environment. Refer to the table titled "Volume and Rate Analysis" for further detail on these decreases. The table titled "Average Balances, Income and Expenses, Yields and Rates" displays the composition of interest earnings assets and interest bearing liabilities and their respective yields and rates for the years ended December 31, 2015, 2014, and 2013.

The net interest margin was 4.06% for 2015, 4.20% for 2014, and 4.24% for 2013. 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 2015, 2014, and 2013. The table titled "Tax-Equivalent Net Interest Income" reconciles net interest income to tax-equivalent net interest income, which is not a measurement under GAAP, for the years ended December 31, 2015, 2014, and 2013.

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

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Average Balances, Income and Expenses, Yields and Rates

(dollars in thousands)

	December 31, 2015			December 31, 2014			December 31, 2013		
	Average Balances	Interest Income/Expense	Average Yield/Rate	Average Balances	Interest Income/Expense	Average Yield/Rate	Average Balances	Interest Income/Expense	Average Yield/Rate
<b>Assets:</b>									
<b>Securities:</b>									
Taxable	\$71,159	\$1,744	2.45 %	\$68,119	\$2,047	3.01 %	\$72,630	\$2,242	3.09 %
Tax-Exempt (1)	31,592	1,472	4.66 %	33,652	1,661	4.94 %	36,692	1,881	5.13 %
Total Securities	\$102,751	\$3,216	3.13 %	\$101,771	\$3,708	3.64 %	\$109,322	\$4,123	3.77 %
<b>Loans:</b>									
Taxable	465,444	21,523	4.62 %	449,247	21,477	4.78 %	422,692	21,352	5.05 %
Non-accrual	6,446	—	— %	6,811	—	— %	2,921	—	— %
Tax-Exempt (1)	7,210	346	4.80 %	5,789	330	5.70 %	4,423	269	6.08 %
Total Loans	\$479,100	\$21,869	4.56 %	\$461,847	\$21,807	4.72 %	\$430,036	\$21,621	5.03 %
Federal funds sold	—	—	— %	—	—	— %	—	—	— %
Interest-bearing deposits in other banks	12,174	26	0.21 %	6,075	12	0.20 %	10,048	23	0.23 %
Total earning assets (2)	\$587,579	\$25,111	4.27 %	\$562,882	\$25,527	4.54 %	\$546,485	\$25,767	4.72 %
Allowance for loan losses	(5,374 )			(5,839 )			(6,957 )		
Total non-earning assets	47,626			43,008			40,573		
Total assets	\$629,831			\$600,051			\$580,101		
<b>Liabilities and Shareholders' Equity:</b>									
<b>Interest-bearing deposits:</b>									
NOW accounts	\$80,809	\$85	0.11 %	\$82,821	\$88	0.11 %	\$83,889	\$103	0.12 %
Money market accounts	99,088	113	0.11 %	94,650	108	0.11 %	87,809	120	0.14 %
Savings accounts	76,054	41	0.05 %	67,515	35	0.05 %	59,114	30	0.05 %
<b>Time deposits:</b>									
\$100,000 and more	36,098	170	0.47 %	35,341	181	0.51 %	38,232	241	0.63 %
Less than \$100,000	57,992	332	0.57 %	61,136	512	0.84 %	65,900	648	0.98 %
Total interest-bearing deposits	\$350,041	\$741	0.21 %	\$341,463	\$924	0.27 %	\$334,944	\$1,142	0.34 %
Federal funds purchased and securities sold under agreements to repurchase	1,154	10	0.87 %	1,865	20	1.07 %	1,064	31	2.91 %
Federal Home Loan Bank advances	24,849	336	1.35 %	28,818	650	2.26 %	32,223	1,094	3.40 %
Trust preferred capital notes (3)	4,441	196	4.41 %	7,217	318	4.41 %	7,217	318	4.41 %
Total interest-bearing liabilities	\$380,485	\$1,283	0.34 %	\$379,363	\$1,912	0.50 %	\$375,448	\$2,585	0.69 %
<b>Noninterest-bearing liabilities:</b>									
Demand deposits	171,508			149,026			136,242		
Other Liabilities	2,599			1,981			3,581		

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Total liabilities	\$554,592		\$530,370		\$515,271
Shareholders' equity	75,239		69,681		64,830
Total liabilities and shareholders' equity	\$629,831		\$600,051		\$580,101
Net interest income		\$23,828		\$23,615	\$23,182
Net interest spread		3.93 %		4.04 %	4.03 %
Interest expense as a percent of average earning assets		0.22 %		0.34 %	0.47 %
Net interest margin		4.06 %		4.20 %	4.24 %

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

(2) Non-accrual loans are not included in this total since they are not considered earning assets.

(3) Interest expense and average yield was adjusted to exclude interest expense related to the interest rate swap incurred after the redemption of the trust preferred capital notes.

Tax-Equivalent Net Interest Income  
(dollars in thousands)

	December 31,		
	2015	2014	2013
GAAP Financial Measurements:			
Interest Income - Loans	\$21,751	\$21,695	\$21,530
Interest Income - Securities and Other Interest-Earnings Assets	2,742	3,155	3,506
Interest Expense - Deposits	741	924	1,142
Interest Expense - Other Borrowings	542	988	1,443
Total Net Interest Income	\$23,210	\$22,938	\$22,451
Non-GAAP Financial Measurements:			
Add: Tax Benefit on Tax-Exempt Interest Income - Loans	\$118	\$112	\$92
Add: Tax Benefit on Tax-Exempt Interest Income - Securities	500	565	639
Total Tax Benefit on Tax-Exempt Interest Income	\$618	\$677	\$731
Tax-Equivalent Net Interest Income	\$23,828	\$23,615	\$23,182

The tax-equivalent yield on earning assets decreased 27 basis points from 2014 to 2015 and 18 basis points from 2013 to 2014. The tax-equivalent yield on securities decreased 51 basis points from 2014 to 2015 and 13 basis points from 2013 to 2014. The tax-equivalent yield on loans decreased 16 basis points from 2014 to 2015 and 31 basis points from 2013 to 2014. The decrease in the yield on earning assets, securities, and the loan portfolio was primarily a result of the low interest rate environment that extended through 2015.

The average rate on interest-bearing liabilities decreased 16 basis points from 2014 to 2015 and 19 basis points from 2013 to 2014. These changes were caused primarily by management of the deposit pricing and product mix, maturity of two higher interest rate FHLB advances during 2014, and the continued low rate environment. An intentional shift in the product mix, to move from time deposits to non-maturity deposits during 2015 was planned and achieved. The average rate on total interest-bearing deposits decreased 6 basis points from 2014 to 2015 and 7 basis points from 2013 to 2014. In general, deposit pricing is done in response to monetary policy actions and yield curve changes. Local competition for funds affects the cost of time deposits, which are primarily comprised of certificates of deposit. The Company issues brokered certificates of deposit as a substitute for offering promotional certificates of deposit when their rates are lower. The rates on brokered certificates of deposit are usually comparable with other wholesale funding sources and these funds can be gathered more efficiently without causing existing deposits to reprice. The Company prefers to rely most heavily on non-maturity deposits, which include NOW accounts, money market accounts, and savings accounts. The average balance of non-maturity interest-bearing deposits increased \$11.0 million or 4.48% from \$245.0 million during 2014 to \$256.0 million in 2015 and \$14.2 million or 6.14% from \$230.8 million at December 31, 2013 during 2014. Changes in the average rate on interest-bearing liabilities can also be affected by the pricing on other sources of funds, namely borrowings. The Company from time to time will utilize overnight borrowings in the form of federal funds purchased. The average rate on these borrowings decreased 20 basis points from 2014 to 2015 and 184 basis points from 2013 to 2014. The cost of federal funds purchased is affected by the Federal Reserve's changes in the federal funds target rate, which increased to 0.50% during 2015 from 0.25% in several years preceding. Finally, the Company borrows from the Federal Home Loan Bank through short and long term advances. The average rate on FHLB advances decreased 91 basis points from 2014 to 2015 and decreased 114 basis points from 2013 to 2014. The average balance on FHLB advances decreased \$4.0 million during 2015 and decreased \$3.4 million during 2014.

As of July 1, 2014, the Company began deferring loan origination fees and related direct loan origination costs in accordance with ASC 310-20. This has a direct impact on the net interest margin and more specifically, the loan yield. Prior to this date, the net impact of deferred loan origination fees and related direct loan origination costs was deemed to be immaterial.

The table titled "Volume and Rate Analysis" provides information about the effect of changes in financial assets and liabilities and changes in rates on net interest income. Non-accruing loans are excluded from the average outstanding loans. Tax-equivalent net interest income increased \$213 thousand during 2015. The increase in tax-equivalent net interest income during 2015 is comprised of an increase due to volume of \$921 thousand and a decrease due to rate of \$708 thousand. The increase in tax-equivalent net interest income during 2015 was primarily affected by the increased volume of taxable loans and the decreased cost of Federal Home Loan Bank advances.

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

(dollars in thousands)

	2015 vs 2014			2014 vs 2013		
	Increase (Decrease)			Increase (Decrease)		
	Due to Changes in:					
	Volume	Rate	Total	Volume	Rate	Total
<b>Earning Assets:</b>						
<b>Securities:</b>						
Taxable	\$96	\$(399)	) \$(303)	) \$(138)	) \$(57)	) \$(195)
Tax-exempt	(98)	) (91)	) (189)	) (152)	) (68)	) (220)
<b>Loans:</b>						
Taxable	643	(597)	) 46	839	(714)	) 125
Tax-exempt	45	(29)	) 16	76	(15)	) 61
Federal funds sold	—	—	—	—	—	—
Interest-bearing deposits in other banks	13	1	) 14	(8)	) (3)	) (11)
Total earning assets	\$699	\$(1,115)	) \$(416)	) \$617	) \$(857)	) \$(240)
<b>Interest-Bearing Liabilities:</b>						
NOW accounts	\$(3)	) \$—	) \$(3)	) \$(2)	) \$(13)	) \$(15)
Money market accounts	5	—	) 5	7	(19)	) (12)
Savings accounts	6	—	) 6	5	—	) 5
<b>Time deposits:</b>						
\$100,000 and more	4	(15)	) (11)	) (17)	) (43)	) (60)
Less than \$100,000	(25)	) (155)	) (180)	) (46)	) (90)	) (136)
Total interest-bearing deposits	\$(13)	) \$(170)	) \$(183)	) \$(53)	) \$(165)	) \$(218)
Federal funds purchased and securities sold under agreements to repurchase	\$(7)	) \$(3)	) \$(10)	) \$2	) \$(13)	) \$(11)
Federal Home Loan Bank advances	(80)	) (234)	) (314)	) (106)	) (338)	) (444)
Trust preferred capital notes	(122)	) —	) (122)	) —	) —	) —
Total interest-bearing liabilities	\$(222)	) \$(407)	) \$(629)	) \$(157)	) \$(516)	) \$(673)
Change in net interest income	\$921	\$(708)	) \$213	\$774	) \$(341)	) \$433

## Provision for Loan Losses

The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses as discussed within the Critical Accounting Policies section above. The provision for (recovery of) loan losses was \$(227) thousand for 2015, \$350 thousand for 2014, and zero for 2013. Changes in the amount of provision for loan losses during each period reflect the results of the Bank's analysis used to determine the adequacy of the allowance for loan losses. The recovery of loan losses in 2015, compared to a provision for loan losses in 2014, reflects lower specific reserves on remaining impaired loans as well as a net recovery amounts. The Company is committed to maintaining an allowance that adequately reflects the risk inherent in the loan portfolio. This commitment is more fully discussed in the "Asset Quality" section.

## Noninterest Income

Total noninterest income was \$8.4 million, \$6.6 million, and \$7.5 million during 2015, 2014, and 2013, respectively. This represents an increase of \$1.8 million or 27.73% for 2015 and a decrease of \$856 thousand or 11.47% for 2014. Management reviews the activities which generate noninterest income on an ongoing basis.

The following table provides the components of noninterest income for the twelve months ended December 31, 2015, 2014, and 2013, which are included within the respective Consolidated Statements of Income headings. The following paragraphs provide information about activities which are included within the respective Consolidated Statements of Income headings. Variances that the Company believes require explanation are discussed below the table.





(dollars in thousands)	December 31,		\$ Change	% Change	2014	2013	\$ Change	% Change	
	2015	2014							
Income from fiduciary activities	\$ 1,338	\$ 1,162	\$ 176	15.15	% \$ 1,162	\$ 1,186	\$(24)	(2.02)	%
Service charges on deposit accounts	1,244	1,323	(79)	(5.97)	% 1,323	1,453	(130)	(8.95)	%
Other service charges and fees	3,375	2,995	380	12.69	% 2,995	3,864	(869)	(22.49)	%
(Loss) on the sale of bank premises and equipment	(76)	(14)	(62)	NM	(14)	(1)	(13)	NM	
Gain on sale of securities	124	990	(866)	NM	990	465	525	NM	
Gain on redemption of trust preferred debt	2,424	—	2,424	NM	—	—	—	NM	
Other operating income	9	150	(141)	(94.00)	% 150	495	(345)	(69.70)	%
Total noninterest income	\$ 8,438	\$ 6,606	\$ 1,832	27.73	% \$ 6,606	\$ 7,462	\$(856)	(11.47)	%

NM - Not Meaningful

Income from fiduciary activities, generated by trust services offered through Eagle Investment Group, increased by \$176 thousand or 15.15% for 2015. 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. In future periods, trust fees for this client will be accrued and billed on a quarterly basis.

The amount of other services charges and fees is comprised primarily of commissions from the sale of non-deposit investment products, fees received from the Bank's credit card program, fees generated from the Bank's ATM/debit card programs, and fees generated from the origination of mortgage loans for the secondary market. Other service charges and fees increased by \$380 thousand or 12.69% for 2015. This increase can be attributed to increased activity in non-deposit investment products and an increase of ATM fee income of \$155 thousand for 2015. Other service charges and fees decreased by \$869 thousand or 22.49% for 2014. In April of 2013, the Company received a signing bonus of \$121 thousand from its current debit card vendor for extending its contract and remaining exclusive to this provider. In addition, in 2013, the Company recorded the sale of the Bank's merchant processing business. The sale of the merchant portfolio resulted in a net gain of \$399 thousand. Total proceeds from the transaction of \$450 thousand are reflected in other service charges and fees while broker, legal and other related expenses are reflected in non-interest expense. These two transactions were a large contributor to the overall decrease during 2014. During 2014, these decreases in other service charges and fees were augmented by a decrease of \$155 thousand or 54.20% in fees generated from the origination of mortgage loans for the secondary market. This decrease is due to decreased volume in this product for 2014.

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 decreased \$141 thousand or 94.00% during 2015. During the third quarter of 2015, the Company's cash flow hedge was derecognized upon the retirement of the trust preferred capital note as discussed in the previous paragraph. As a result, the loss on the interest rate swap derivative contract recorded in accumulated other comprehensive income of \$237 thousand was reclassified to the income statement during the third quarter, which was partially offset by the adjustment of the derivative contract to fair value for a gain of \$88 thousand. Other operating income decreased \$345 thousand or 69.70% during 2014. During 2013, the Company recorded \$254 thousand of

income related to the proceeds received from a bank owned life insurance policy, which was the majority of the 2014 decrease.

Several one time events, as noted above, including a gain on redemption of trust preferred debt, security gains from sales, the sale of the merchant card portfolio, the receipt of life insurance benefits and the adjustment made to the the trust fees receivable account, have helped to mitigate declining interest income during 2015, 2014 and 2013.

## Noninterest Expenses

Total noninterest expenses were \$22.5 million, \$20.0 million, and \$20.4 million during 2015, 2014, and 2013, respectively. This represents an increase of \$2.5 million or 12.48% during 2015 and a decrease of \$381 thousand or 1.87% during 2014. The efficiency ratio of the Company was 75.77%, 67.59%, and 65.36% for 2015, 2014, and 2013, respectively. The efficiency ratio is calculated by dividing total noninterest expenses by the sum of tax-equivalent net interest income and total noninterest income, excluding certain non-recurring gains and losses. A reconciliation of tax-equivalent net interest income, which is not a measurement under GAAP, to net interest income is presented within the Net Interest Income section above.

The following table provides the components of noninterest expense for the twelve months ended December 31, 2015, 2014, and 2013, which are included within the respective Consolidated Statements of Income headings. The following paragraphs provide information about activities which are included within the respective Consolidated Statements of Income headings. Variances that the Company believes require explanation are discussed below the table.

(dollars in thousands)	December 31,		\$ Change	% Change	2014	2013	\$ Change	% Change	
	2015	2014							
Salaries and employee benefits	\$12,318	\$11,427	\$891	7.80	% \$11,427	\$11,451	\$(24)	(0.21)	%
Occupancy expenses	1,563	1,280	283	22.11	% 1,280	1,291	(11)	(0.85)	%
Equipment expenses	1,102	720	382	53.06	% 720	666	54	8.11	%
Advertising and marketing expenses	612	571	41	7.18	% 571	548	23	4.20	%
Stationery and supplies	242	307	(65)	(21.17)	% 307	274	33	12.04	%
ATM network fees	805	712	93	13.06	% 712	616	96	15.58	%
Other real estate owned expense	336	27	309	1,144.44	% 27	40	(13)	(32.50)	%
(Gain) loss on foreclosure and sale of other real estate owned	(46)	(82)	)36	NM	(82)	)140	(222)	)NM	
FDIC assessment	439	357	82	22.97	% 357	375	(18)	(4.80)	%
Computer software expense	696	872	(176)	(20.18)	% 872	664	208	31.33	%
Bank franchise tax	505	466	39	8.37	% 466	407	59	14.50	%
Professional fees	1,025	988	37	3.74	% 988	1,013	(25)	(2.47)	%
Other bank services charges	71	73	(2)	(2.74)	% 73	695	(622)	(89.50)	%
Cost to terminate operating lease	520	—	520	NM	—	—	—	NM	
Other operating expenses	2,293	2,268	25	1.10	% 2,268	2,187	81	3.70	%
Total noninterest expenses	\$22,481	\$19,986	\$2,495	12.48	% \$19,986	\$20,367	\$(381)	(1.87)	%

NM - Not Meaningful

The Company has hired additional retail staff for the opening of two new retail branches. Six new employees were hired for the One Loudoun branch located in Ashburn, Virginia. This branch opened in April 2015. The second new branch, located in Leesburg, Virginia, opened in August 2015. During 2015, seven employees were hired for that facility. Additionally, in February 2015, with the decision to no longer outsource its internal audit function, the Company hired a Director of Internal Audit. Additional hires of middle management positions were also made during the first quarter of 2015 to address infrastructure and growth needs. These branching and hiring efforts have impacted salaries and employee benefits, occupancy expenses, equipment expenses and advertising and marketing expenses. Stationary and supplies expense has decreased during 2015 due to efforts to promote paperless statements to customers as well as internal efforts to maintain paperless records where possible.

ATM network fees increased 13.06% during 2015 and 15.58% during 2014. ATM network fees fluctuate based on the usage of ATM and debit cards. This expense has increased similarly to increases in deposit accounts.

Other real estate owned expenses increased during 2015. This fluctuation is due mainly to a valuation adjustment of \$288 thousand that were recorded during 2015. No valuation allowances were established during 2014 and 2013.

FDIC assessments increased \$82 thousand or 22.97% during 2015. During 2015 there were increases in the total assessment base as well as the quarterly multiplier, which caused the overall expense to increase.

Computer software expense decreased during 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. Computer software expense increased during 2014 due to branch growth as well as increased regulations requiring investment in additional software products.

Other bank service charges decreased significantly during 2014. Noninterest expense was negatively impacted in 2013 by the Company's election to prepay a \$10.0 million outstanding advance with the Federal Home Loan Bank of Atlanta. A \$612 thousand prepayment fee was incurred by the Company in December 2013 in conjunction with the repayment of the advance.

On June 10, 2015, the Company purchased the land on which one of its retail branches resided. The land was purchased subject to an existing lease and subsequently recorded at market value, resulting in a write down of the total purchase price. This writedown appears in the Consolidated Statement of Income as a Cost to terminate operating lease.

#### Income Taxes

Income tax expense was \$2.4 million, \$2.1 million, and \$2.4 million for the years ended December 31, 2015, 2014, and 2013, respectively. The change in income tax expense can be attributed to changes in taxable earnings at the federal statutory income tax rate of 34%. These amounts correspond to an effective tax rate of 26.08%, 22.46%, and 25.02% for 2015, 2014, and 2013, respectively. The decrease in the effective tax rate for 2014 was mainly due to investments in tax credits that were deductible in that same year. Note 9 to the Consolidated Financial Statements provides a reconciliation between income tax expense computed using the federal statutory income tax rate and the Company's actual income tax expense during 2015, 2014, and 2013.

#### FINANCIAL CONDITION

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

The Company's total assets were \$653.3 million at December 31, 2015, an increase of \$23.1 million or 3.67% from \$630.2 million at December 31, 2014. Securities increased \$11.6 million or 12.38% from 2014 to 2015. Loans, net of allowance for loan losses, increased by \$25.9 million or 5.57% from 2014 to 2015. Total liabilities were \$575.1 million at December 31, 2015, compared to \$557.0 million at December 31, 2014. Total shareholders' equity at year end 2015 and 2014 was \$78.2 million and \$73.1 million, respectively.

##### Securities

Total securities, excluding restricted stock at December 31, 2015 were \$105.8 million as compared to \$94.2 million as of December 31, 2014, which represents an increase of \$11.6 million or 12.38% during 2015. The table titled "Securities Portfolio" shows the carrying value of securities at December 31, 2015, 2014, and 2013. The Company purchased \$33.5 million in securities during 2015. This amount includes \$8.8 million or 26.45% in obligations of U.S. government corporations and agencies, \$19.7 million or 58.83% in mortgage-backed securities and \$4.9 million or 14.72% in obligations of states and political subdivisions. The Company had \$17.4 million in maturities, calls, and principal repayments on securities during 2015. This amount includes \$8.4 million or 48.55% in obligations of U.S. government corporations and agencies, \$3.8 million or 21.86% in mortgage-backed securities and \$5.1 million or 29.59% in obligations of states and political subdivisions. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity as of December 31, 2015. Note 2 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio as of December 31, 2015 and 2014.

Securities Portfolio  
(dollars in thousands)

	December 31,		
	2015	2014	2013
Securities available for sale:			
Obligations of U.S. government corporations and agencies	\$37,665	\$37,211	\$34,744
Mortgage-backed securities	28,931	15,779	15,197
Obligations of states and political subdivisions	39,227	40,410	43,116
Corporate securities	—	765	8,423
Equity securities	—	—	1,118
	\$105,823	\$94,165	\$102,598

The ability to dispose of available for sale securities prior to maturity provides management more options to react to future rate changes and provides more liquidity, when needed, to meet short-term obligations. The Company had a net unrealized gain on available for sale securities of \$1.5 million and \$2.2 million at December 31, 2015 and 2014, respectively. Unrealized gains or losses on available for sale securities are reported within shareholders' equity, net of the related deferred tax effect, as accumulated other comprehensive income.

The table titled "Maturity Distribution and Yields of Securities" shows the maturity period and average yield for the different types of securities in the portfolio at December 31, 2015. Although mortgage-backed securities have definitive maturities, they provide monthly principal curtailments which can be reinvested at a prevailing rate and for a different term.

Maturity Distribution and Yields of Securities  
(dollars in thousands)

	December 31, 2015									
	Due in one year or less		Due after 1 through 5 years		Due after 5 through 10 years		Due after 10 years and Equity Securities		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available for sale:										
Obligations of U.S. government corporations and agencies	\$3,004	1.57 %	\$17,293	1.90 %	\$16,402	2.36 %	\$966	3.00 %	\$37,665	2.10 %
Mortgage-backed securities	—	— %	—	— %	3,376	2.34 %	25,555	2.57 %	28,931	2.54 %
Obligations of states and political subdivisions, taxable	—	— %	4,409	3.54 %	1,829	3.93 %	2,070	4.28 %	8,308	3.81 %
Total taxable	\$3,004	1.57 %	\$21,702	2.23 %	\$21,607	2.49 %	\$28,591	2.71 %	\$74,904	2.46 %
Obligations of states and political subdivisions, tax-exempt (1)	1,411	3.55 %	9,536	2.92 %	16,760	3.12 %	3,212	3.41 %	30,919	3.11 %
Total	\$4,415	2.20 %	\$31,238	2.44 %	\$38,367	2.76 %	\$31,803	2.77 %	\$105,823	2.65 %

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

Loan Portfolio

The Company's primary use of funds is supporting lending activities from which it derives the greatest amount of interest income. Gross loans were \$495.6 million and \$469.8 million at December 31, 2015 and 2014, respectively. This represents an increase of \$25.8 million or 5.48% for 2015. The ratio of loans to deposits decreased during the year from 92.24% to 89.09% at December 31, 2014 and December 31, 2015, respectively. The table titled "Loan Portfolio" shows the composition of the loan portfolio over the last five years.



## Loan Portfolio

(dollars in thousands)

	December 31,				
	2015	2014	2013	2012	2011
Loans secured by real estate:					
Construction and land development	\$35,019	\$25,887	\$27,047	\$30,846	\$31,579
Secured by farmland	6,550	10,602	9,886	7,030	3,390
Secured by 1-4 family residential properties	229,651	224,694	218,633	214,619	212,638
Multifamily	3,975	3,016	2,850	2,808	4,517
Commercial	175,172	161,299	148,166	124,382	118,043
Loans to farmers	1,331	957	1,321	1,525	1,910
Commercial and industrial loans	29,366	28,132	20,865	21,640	22,866
Consumer installment loans	13,530	13,874	13,785	13,307	13,185
All other loans	979	1,359	1,720	1,940	2,296
Total loans	\$495,573	\$469,820	\$444,273	\$418,097	\$410,424

Loans secured by real estate were \$450.4 million or 90.88% and \$425.5 million or 90.57% of total loans at December 31, 2015 and 2014, respectively. This represents an increase of \$24.9 million or 5.84% for 2015. Consumer installment loans were \$13.5 million or 2.73% and \$13.9 million or 2.95% of total loans at December 31, 2015 and 2014, respectively. This represents a decrease of \$344 thousand or 2.48% for 2015. Commercial and industrial loans were \$29.4 million or 5.93% and \$28.1 million or 5.99% of total loans at December 31, 2015 and 2014. This represents an increase of \$1.3 million or 4.39% for 2015.

The table titled "Maturity Schedule of Selected Loans" shows the different loan categories and the period during which they mature. For loans maturing in more than one year, the table also shows a breakdown between fixed rate loans and floating rate loans. The table indicates that \$340.8 million or 68.76% of the loan portfolio matures within five years.

The floating rate loans maturing after five years are primarily comprised of home equity lines of credit.

## Maturity Schedule of Selected Loans

(dollars in thousands)

	December 31, 2015			
	Within 1 Year	After 1 Year Within 5 Years	After 5 Years	Total
Loans secured by real estate:				
Construction and land development	\$23,433	\$8,690	\$2,896	\$35,019
Secured by farmland	1,056	4,692	802	6,550
Secured by 1-4 family residential properties	43,064	102,610	83,977	229,651
Multifamily	570	2,112	1,293	3,975
Commercial	17,918	96,748	60,506	175,172
Loans to farmers	412	671	248	1,331
Commercial and industrial loans	14,829	9,841	4,696	29,366
Consumer installment loans	1,198	11,951	381	13,530
All other loans	—	966	13	979
	\$102,480	\$238,281	\$154,812	\$495,573
For maturities over one year:				
Floating rate loans		\$10,167	\$45,919	\$56,086
Fixed rate loans		228,114	108,893	337,007

\$238,281

\$154,812

\$393,093

### Asset Quality

The Company has policies and procedures designed to control credit risk and to maintain the quality of its loan portfolio. These include underwriting standards for new originations and ongoing monitoring and reporting of asset quality and adequacy of the allowance for loan losses. There were \$5.9 million in total non-performing assets, which consist of nonaccrual loans, other real estate owned, and repossessed assets at December 31, 2015. This is a decrease of \$6.9 million when compared to the December 31, 2014 balance of \$12.8 million. This decrease resulted mostly from the decrease in nonaccrual loans as discussed below.

Nonaccrual loans were \$5.3 million at December 31, 2015 and \$10.7 million at 2014. The gross amount of interest income that would have been recognized on nonaccrual loans was \$63 thousand for 2015 and \$108 thousand for 2014. None of this interest income was included in net income for 2015 or 2014. A total of 3 loans were placed in nonaccrual during 2015. In addition, 26 loans totaling \$4.5 million were removed from nonaccrual status during 2015. Of the \$4.5 million in loans removed from nonaccrual status between December 31, 2014 and December 31, 2015, 16 loans totaling \$3.0 million were returned to accruing status, 5 loans totaling \$844 thousand were paid off and 5 loans totaling \$649 thousand were written off. Management evaluates the financial condition of these borrowers and the value of any collateral on these loans. The results of these evaluations are used to estimate the amount of losses which may be realized on the disposition of these nonaccrual loans. Nonaccrual loans that were evaluated for impairment at December 31, 2015 totaled \$5.3 million and had \$146 thousand in specific allocations.

Other real estate owned decreased to \$571 thousand at December 31, 2015, compared to \$2.1 million at December 31, 2014. Ten foreclosed properties were sold during 2015, while five foreclosed properties were acquired. When the property is sold, the difference between the amount of other real estate owned and the settlement proceeds is recognized as a gain or loss on the sale of other real estate owned. A net gain of \$46 thousand and \$82 thousand was recognized on the foreclosure and sale of other real estate owned during 2015 and 2014, respectively. A net loss of \$140 thousand was recognized on the sale of other real estate owned during 2013.

Total loans past due 90 days or more and still accruing interest were \$307 thousand or 0.06%, \$6 thousand or 0.00%, and \$11 thousand or 0.00% of total loans at December 31, 2015, 2014, and 2013, respectively. The loans past due 90 days or more and still accruing interest are well secured and in the process of collection; therefore, they were not classified as nonaccrual.

### Nonperforming and Other Assets

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

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

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

In addition, the Company may, under certain circumstances, restructure loans in troubled debt restructurings as a concession to a borrower when the borrower is experiencing financial distress. Formal, standardized loan restructuring programs are not utilized by the Company. Each loan considered for restructuring is evaluated based on customer circumstances and may include modifications to one or more loan provisions. Such restructured loans are included in

impaired loans. At December 31, 2015, 2014, 2013, 2012, and 2011, the Company had \$7.5 million, \$7.8 million, \$6.4 million, \$8.2 million, and \$10.7 million in restructured loans, respectively.

Nonperforming Assets  
(dollars in thousands)

	December 31,					
	2015	2014	2013	2012	2011	
Nonaccrual loans	\$5,285	\$10,706	\$4,412	\$2,414	\$2,449	
Other real estate owned and repossessed assets	571	2,109	1,646	2,934	2,423	
Total nonperforming assets	\$5,856	\$12,815	\$6,058	\$5,348	\$4,872	
Loans past due 90 days and accruing interest	\$307	\$6	\$11	\$208	\$94	
Allowance for loan losses to nonperforming assets	85	% 40	% 91	% 123	% 179	%
Non-performing assets to period end loans and other real estate owned	1.18	% 2.72	% 1.36	% 1.27	% 1.18	%

Other potential problem loans are defined as performing loans that possess certain risks that management has identified that could result in the loans not being repaid in accordance with their terms. Accordingly, these loans are risk rated at a level of substandard or lower. At December 31, 2015, other potential problem loans totaled \$4.6 million. Of the total other potential problem loans, \$4.6 million or 100.00% are currently considered impaired and are disclosed in Note 4 to the Consolidated Financial Statements.

#### Allowance for Loan Losses

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

Charged-off loans were \$456 thousand, \$1.5 million, and \$1.3 million for 2015, 2014, and 2013, respectively.

Recoveries were \$562 thousand, \$725 thousand, and \$233 thousand for 2015, 2014, and 2013, respectively. Net recoveries were \$106 thousand for 2015. Net charge-offs were \$758 thousand, and \$1.1 million for 2014 and 2013, respectively. This represents a decrease in net charge-offs of \$864 thousand or 113.98% for 2015 and a decrease of \$331 thousand or 30.39% for 2014. The allowance for loan losses as a percentage of loans was 1.00%, 1.08%, and 1.24% at the end of 2015, 2014, and 2013, respectively. The decreases in allowance for loan losses as a percentage of total loans from December 31, 2014 to December 31, 2015 is primarily due to positive trends in nonperforming assets (including nonaccrual loans), impaired loans and adversely risk rated loans, as well as a net recovery position for 2015. In addition, the Company was diligent in maintaining updated appraisals for collateral-dependent impaired loans, which resulted in an overall decrease in specific reserves in the allowance for loan losses during 2015. The allowance for loan losses at year-end covered net charge-offs during the year by 6.70 times for 2014 and 5.04 times for 2013. The ratio of net (recoveries) charge-offs to average loans was (0.02)% for 2015, 0.16% for 2014, and 0.25% for 2013.

The (recovery of) provision for loan losses for the year ended December 31, 2015 was \$(227) thousand, compared to \$350 thousand and zero for the years ended December 31, 2014 and 2013, respectively. The recovery of loan losses compared to last years provision for loan losses reflects reductions in impaired loans as well as non-performing assets combined with a net recovery position for 2015.

The table titled "Allocation of Allowance for Loan Losses" shows the amount of the allowance for loan losses which is allocated to the indicated loan categories, along with that category's percentage of total loans, at December 31, 2015, 2014, 2013, 2012, and 2011. The amount of allowance for loan losses allocated to each loan category is based on the amount delinquent loans in that loan category, the status of nonperforming assets in that loan category, the historical losses for that loan category, and the financial condition of certain borrowers whose financial conditional is monitored

on a periodic basis. Management believes that the allowance for loan losses is adequate based on the loan portfolio's current risk characteristics.

Analysis of Allowance for Loan Losses  
(dollars in thousands)

	December 31,					
	2015	2014	2013	2012	2011	
Balance, beginning of period	\$5,080	\$5,488	\$6,577	\$8,743	\$7,111	
Loans charged-off:						
Commercial, financial and agricultural	—	—	403	207	596	
Real estate-construction and land development	166	482	20	1,313	710	
Real estate-mortgage	199	891	796	2,499	1,204	
Consumer	91	110	103	144	456	
Total loans charged off	\$456	\$1,483	\$1,322	\$4,163	\$2,966	
Recoveries:						
Commercial, financial and agricultural	\$181	\$164	\$47	\$36	\$137	
Real estate-construction and land development	75	26	5	4	5	
Real estate-mortgage	257	444	116	213	299	
Consumer	49	91	65	84	407	
Total recoveries	\$562	\$725	\$233	\$337	\$848	
Net (recoveries) charge-offs	(106 )	758	1,089	3,826	2,118	
(Recovery of) provision for loan losses	(227 )	350	—	1,660	3,750	
Balance, end of period	\$4,959	\$5,080	\$5,488	\$6,577	\$8,743	
Ratio of allowance for loan losses to loans outstanding at period end	1.00	% 1.08	% 1.24	% 1.57	% 2.13	%
Ratio of net charge offs to average loans outstanding during the period	(0.02 )	% 0.16	% 0.25	% 0.91	% 0.52	%

Allocation of Allowance for Loan Losses  
(dollars in thousands)

	Commercial, Financial, and Agricultural		Real Estate Construction		Real Estate Mortgage		Consumer and Other Loans	
	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans
December 31, 2015	\$211	5.9 %	\$775	8.4 %	\$3,590	82.5 %	\$162	3.2 %
December 31, 2014	464	6.0 %	951	7.8 %	3,324	82.8 %	145	3.4 %
December 31, 2013	555	4.7 %	1,032	8.3 %	3,562	83.2 %	184	3.8 %
December 31, 2012	880	5.2 %	1,280	9.0 %	4,002	81.8 %	229	4.0 %
December 31, 2011	1,077	5.6 %	2,618	8.5 %	4,601	81.7 %	254	4.2 %

## Deposits

Total deposits were \$550.7 million and \$503.8 million at December 31, 2015 and 2014, respectively, which represents an increase of \$46.9 million or 9.31% during 2015. The table titled "Average Deposits and Rates Paid" shows the average deposit balances and average rates paid for 2015, 2014 and 2013.

## Average Deposits and Rates Paid

(dollars in thousands)

	December 31,		2014		2013			
	2015		2014		2013			
	Amount	Rate	Amount	Rate	Amount	Rate		
Noninterest-bearing	\$ 171,508		\$ 149,026		\$ 136,242			
Interest-bearing:								
NOW accounts	80,809	0.11	% 82,821	0.11	% 83,889	0.12	%	
Money market accounts	99,088	0.11	% 94,650	0.11	% 87,809	0.14	%	
Regular savings accounts	76,054	0.05	% 67,515	0.05	% 59,114	0.05	%	
Time deposits:								
\$100,000 and more	36,098	0.47	% 35,341	0.51	% 38,232	0.63	%	
Less than \$100,000	57,992	0.57	% 61,136	0.84	% 65,900	0.98	%	
Total interest-bearing	\$ 350,041	0.21	% \$ 341,463	0.27	% \$ 334,944	0.34	%	
Total deposits	\$ 521,549		\$ 490,489		\$ 471,186			

Noninterest-bearing demand deposits, which are comprised of checking accounts, increased \$26.7 million or 16.81% from \$159.4 million at December 31, 2014 to \$186.1 million at December 31, 2015. Interest-bearing deposits, which include NOW accounts, money market accounts, regular savings accounts and time deposits, increased \$20.1 million or 5.84% from \$344.5 million at December 31, 2014 to \$364.6 million at December 31, 2015. Total NOW account balances increased \$4.8 million or 5.84% from \$81.4 million at December 31, 2014 to \$86.2 million at December 31, 2015. Total money market account balances increased \$7.3 million or 7.37% from \$98.3 million at December 31, 2014 to \$105.6 million at December 31, 2015. Total regular savings account balances increased \$10.9 million or 15.68% from \$69.6 million at December 31, 2014 to \$80.5 million at December 31, 2015. Time deposits decreased \$2.8 million or 2.93% from \$95.2 million at December 31, 2014 to \$92.4 million at December 31, 2015. Pricing decisions made by management and influenced by the low interest rate environment resulted in the decline in certificate of deposits. Brokered certificates of deposits remained stable at \$12.9 million at December 31, 2014 and December 31, 2015. This included \$11.0 million of traditional brokered certificates of deposit and \$1.9 million of certificates obtained through the CDARS network. The Bank joined the CDARS network in 2008, which allows it to offer over \$50 million in FDIC insurance on a certificate of deposit.

The Company attempts to fund asset growth with deposit accounts and focus upon core deposit growth as its primary source of funding. Core deposits consist of checking accounts, NOW accounts, money market accounts, regular savings accounts, and time deposits of less than \$250,000, including brokered certificates of deposit. Core deposits totaled \$525.8 million or 95.48% and \$481.6 million or 95.59% of total deposits at December 31, 2015 and 2014, respectively.

The table titled "Maturities of Certificates of Deposit and Other Time Deposits of \$100,000 and Greater" shows the amount of certificates of deposit of \$100,000 and more maturing within the time period indicated at December 31, 2015. The total amount maturing within one year is \$27.6 million or 75.01% of the total amount outstanding.



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

	Within Three Months	Three to Six Months	Six to Twelve Months	Over One Year	Total	Percent of Total Deposits	
December 31, 2015	\$7,176	\$5,757	\$14,649	\$9,187	\$36,769	6.68	%

### CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity on December 31, 2015 was \$78.2 million, reflecting a percentage of total assets of 11.97% as compared to \$73.1 million and 11.67% at December 31, 2014. The common stock's book value per share increased \$1.24 or 5.90% to \$22.25 per share at December 31, 2015 from \$21.01 per share at December 31, 2014. During 2015, the Company paid \$0.80 per share in dividends as compared to \$0.77 per share for 2014 and \$0.76 per share for 2013. The Company has a Dividend Investment Plan that allows participating shareholders to reinvest the dividends in Company stock.

#### Analysis of Capital

(dollars in thousands)

	December 31, 2015	December 31, 2014	
Tier 1 Capital:			
Common stock	\$8,758	\$8,621	
Capital surplus	13,730	12,618	
Retained earnings	54,682	50,578	
Trust preferred capital notes	—	7,000	
Total Tier 1 capital	\$77,170	\$78,817	
Common equity Tier 1 capital	\$77,170	\$78,817	
Tier 2 Capital:			
Allowance for loan losses	\$4,986	\$5,106	
Total Tier 2 capital	\$4,986	\$5,106	
Total risk-based capital	\$82,156	\$83,923	
Risk weighted assets	\$507,090	\$440,277	
Risk Based Capital Ratios:			
Common equity Tier 1 capital ratio	15.22	% N/A	
Tier 1 risk-based capital ratio	15.22	% 17.90	%
Total risk-based capital ratio	16.20	% 19.06	%
Tier 1 leverage ratio	12.13	% 12.86	%

Federal regulatory risk-based capital guidelines require percentages to be applied to various assets, including off-balance sheet assets, based on their perceived risk in order to calculate risk-weighted assets. Tier 1 capital consists of total shareholders' equity plus qualifying trust preferred securities outstanding less net unrealized gains and losses on available for sale securities, goodwill and other intangible assets. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses and any excess trust preferred securities that do not qualify as Tier 1 capital. The \$7,000,000 in trust preferred securities, issued by the Company during 2007, qualified as Tier 1 capital at December 31, 2014 because this amount does not exceed 25% of total capital, including the trust preferred securities.

In July 2013, the Federal Reserve issued final rules to include technical changes to its market risk capital rules to align them with the Basel III regulatory capital framework and meet certain requirements of the Dodd-Frank Act. Effective January 1, 2015, the final rules require the Company and the Bank to comply with the following minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6.0% of risk-weighted assets (increased from the prior requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4.0% of total assets (unchanged from the prior requirement). 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. The capital conservation buffer requirement will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. 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. The table titled "Analysis of Capital" shows the components of Tier 1 capital, Tier 2 capital, the amount of total risk-based capital and risk-weighted assets, and the risk based capital ratios for the Company at December 31, 2015 and 2014. Beginning January 1, 2015, the Company calculates its regulatory capital under the U.S. Basel III Standardized Approach. The Company calculated regulatory capital measures for periods prior to 2015 under previous regulatory requirements.

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

## LIQUIDITY

Liquidity management involves meeting the present and future financial obligations of the Company with the sale or maturity of assets or with the occurrence of additional liabilities. Liquidity needs are met with cash on hand, deposits in banks, federal funds sold, securities classified as available for sale and loans maturing within one year. At December 31, 2015 liquid assets totaled \$227.9 million as compared to \$219.2 million at December 31, 2014. These amounts represent 39.64% and 39.59% of total liabilities at December 31, 2015 and 2014, respectively. Securities provide a constant source of liquidity through paydowns and maturities. Also, the Company maintains short-term borrowing arrangements, namely federal funds lines of credit, with larger financial institutions as an additional source of liquidity. The Bank's membership with the Federal Home Loan Bank of Atlanta also provides a source of borrowings with numerous rate and term structures. The Company's senior management monitors the liquidity position regularly and attempts to maintain a position which utilizes available funds most efficiently. As a result of the Company's management of liquid assets and the ability to generate liquidity through liability funding, management

believes that the Company maintains overall liquidity sufficient to satisfy its depositors' requirements and meet its customers' credit needs.

## OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

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

The table titled “Contractual Obligations and Scheduled Payments” presents the Company’s contractual obligations and scheduled payment amounts due within the period indicated at December 31, 2015.

Contractual Obligations and Scheduled Payments  
(dollars in thousands)

	December 31, 2015				Total
	Less than One Year	One Year through Three Years	Three Years through Five Years	More than Five Years	
FHLB advances	\$—	\$20,000	\$—	\$—	\$20,000
Operating leases	200	400	413	2,164	3,177
	\$200	\$20,400	\$413	\$2,164	\$23,177

The \$20.0 million in outstanding FHLB advances is comprised of one (1) advance. Note 8 to the Consolidated Financial Statements discusses the rates, terms, and conversion features on this advance. The payments due on operating leases are discussed in Note 6 to the Consolidated Financial Statements.

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

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

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

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

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

Assumed Market Interest Rate Shock	Change in Net Interest Income		
	Dollars	Percent Change	
-100 BP	\$(1,036	) (4.41	)%
+100 BP	206	0.88	%
+200 BP	283	1.21	%
+300 BP	413	1.76	%
+400 BP	525	2.24	%

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



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

Static EVE Change

(dollars in thousands)

Assumed Market Interest Rate Shift	Change in EVE	
	Dollars	Percent Change
-100 BP Shock	\$(17,753)	(16.57)%
+100 BP Shock	7,935	7.41%
+200 BP Shock	11,535	10.77%
+300 BP Shock	14,293	13.34%
+400 BP Shock	16,338	15.25%





Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
Eagle Financial Services, Inc.  
Berryville, Virginia

We have audited the accompanying consolidated balance sheet of Eagle Financial Services, Inc. and Subsidiary as of December 31, 2015, and the related statements of income, comprehensive income, changes in shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the 2015 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Eagle Financial Services, Inc. and Subsidiary as of December 31, 2015, and the results of their operations and their cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

/s/ Yount, Hyde & Barbour, P.C.

Winchester, Virginia  
March 29, 2016

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of  
Eagle Financial Services, Inc.  
Berryville, Virginia

We have audited the accompanying consolidated balance sheet of Eagle Financial Services, Inc. and its subsidiaries as of December 31, 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2014. The management of Eagle Financial Services, Inc. and its subsidiaries (the "Company") is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Eagle Financial Services, Inc. and its subsidiaries as of December 31, 2014, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America.

/s/Smith Elliott Kearns & Company, LLC  
SMITH ELLIOTT KEARNS & COMPANY, LLC

Chambersburg, Pennsylvania  
March 30, 2015

## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

## Consolidated Balance Sheets

December 31, 2015 and 2014

(dollars in thousands, except share amounts)

	2015	2014
Assets		
Cash and due from banks	\$ 11,082	\$ 9,075
Interest-bearing deposits with other institutions	12,139	25,489
Total cash and cash equivalents	23,221	34,564
Securities available for sale, at fair value	105,823	94,165
Restricted investments	1,896	2,808
Loans	495,573	469,820
Allowance for loan losses	(4,959)	(5,080)
Net Loans	490,614	464,740
Bank premises and equipment, net	20,964	19,015
Other real estate owned, net of allowance	571	2,102
Other assets	10,183	12,764
Total assets	\$ 653,272	\$ 630,158
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest bearing demand deposits	\$ 186,133	\$ 159,352
Savings and interest bearing demand deposits	272,214	249,305
Time deposits	92,371	95,159
Total deposits	\$ 550,718	\$ 503,816
Federal Home Loan Bank advances	20,000	40,000
Trust preferred capital notes	—	7,217
Other liabilities	4,333	5,993
Total liabilities	\$ 575,051	\$ 557,026
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 2015, 3,517,648 including 14,401 unvested restricted stock; issued and outstanding 2014, 3,463,665 including 15,151 unvested restricted stock	8,758	8,621
Surplus	13,730	12,618
Retained earnings	54,682	50,578
Accumulated other comprehensive income	1,051	1,315
Total shareholders' equity	\$ 78,221	\$ 73,132
Total liabilities and shareholders' equity	\$ 653,272	\$ 630,158
See Notes to Consolidated Financial Statements		

## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

## Consolidated Statements of Income

Years Ended December 31, 2015, 2014, and 2013

(dollars in thousands, except per share amounts)

	2015	2014	2013
Interest and Dividend Income			
Interest and fees on loans	\$21,751	\$21,695	\$21,530
Interest and dividends on securities available for sale:			
Taxable interest income	1,645	1,825	2,055
Interest income exempt from federal income taxes	972	1,096	1,241
Dividends	99	222	187
Interest on deposits in banks	26	12	23
Total interest and dividend income	\$24,493	\$24,850	\$25,036
Interest Expense			
Interest on deposits	741	924	1,142
Interest on federal funds purchased and securities sold under agreements to repurchase	10	20	31
Interest on Federal Home Loan Bank advances	336	650	1,094
Interest on trust preferred capital notes	78	132	135
Interest on interest rate swap	182	186	183
Total interest expense	\$1,347	\$1,912	\$2,585
Net interest income	\$23,146	\$22,938	\$22,451
(Recovery Of) Provision For Loan Losses	(227 )	350	—
Net interest income after (recovery of) provision for loan losses	\$23,373	\$22,588	\$22,451
Noninterest Income			
Income from fiduciary activities	\$1,338	\$1,162	\$1,186
Service charges on deposit accounts	1,244	1,323	1,453
Other service charges and fees	3,375	2,995	3,864
(Loss) on sale of bank premises and equipment	(76 )	(14 )	(1 )
Gain on sale of securities	124	990	465
Gain on redemption of trust preferred debt	2,424	—	—
Other operating income	9	150	495
Total noninterest income	\$8,438	\$6,606	\$7,462
Noninterest Expenses			
Salaries and employee benefits	\$12,318	\$11,427	\$11,451
Occupancy expenses	1,563	1,280	1,291
Equipment expenses	1,102	720	666
Advertising and marketing expenses	612	571	548
Stationery and supplies	242	307	274
ATM network fees	805	712	616
Other real estate owned expense	336	27	40
(Gain) loss on foreclosure and sale of other real estate owned	(46 )	(82 )	140
FDIC assessment	439	357	375
Computer software expense	696	872	664
Bank franchise tax	505	466	407
Professional fees	1,025	988	1,013
Other bank service charges	71	73	695
Cost to terminate operating lease	520	—	—
Other operating expenses	2,293	2,268	2,187

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Total noninterest expenses	\$22,481	\$19,986	\$20,367
Income before income taxes	\$9,330	\$9,208	\$9,546
Income Tax Expense	2,433	2,068	2,388
Net income	\$6,897	\$7,140	\$7,158
Earnings Per Share			
Net income per common share, basic	\$1.97	\$2.08	\$2.11
Net income per common share, diluted	\$1.97	\$2.08	\$2.11
See Notes to Consolidated Financial Statements			

46

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## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

## Consolidated Statements of Comprehensive Income

Years Ended December 31, 2015, 2014, and 2013

(dollars in thousands)

	2015	2014	2013
Net income	\$6,897	\$7,140	\$7,158
Other comprehensive (loss) income:			
Changes in benefit obligations and plan assets for post retirement benefit plans, net of deferred income tax expense (benefit) of \$0, (\$3) and \$0 for the years ended December 31, 2015, 2014, and 2013, respectively		(5 )	—
Unrealized (loss) gain on available for sale securities, net of deferred income tax (benefit) expense of (\$234), \$473, and (\$1,687) for the years ended December 31, 2015, 2014, and 2013, respectively	(454 )	919	(3,275 )
Change in fair value of interest rate swap, net of deferred income tax expense of \$99, \$49, and \$69 for the years ended December 31, 2015, 2014 and 2013, respectively	190	96	132
Total other comprehensive (loss) income	(264 )	1,010	(3,143 )
Total comprehensive income	\$6,633	\$8,150	\$4,015
See Notes to Consolidated Financial Statements			

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY  
Consolidated Statements of Changes in Shareholders' Equity  
Years Ended December 31, 2015, 2014, and 2013  
(dollars in thousands, except per share amounts)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2012	\$8,340	\$10,424	\$41,494	\$3,448	\$63,706
Net income			\$7,158		7,158
Other comprehensive (loss)				\$(3,143)	(3,143)
Restricted stock awards, stock incentive plan (13,699)	34	(34)			—
Income tax expense on vesting of restricted stock		35			35
Income tax benefit on disqualifying disposition of stock options exercised		5			5
Stock options exercised (3,872 shares)	10	59			69
Stock based compensation expense		305			305
Issuance of common stock, dividend investment plan (30,627 shares)	77	585			662
Issuance of common stock, employee benefit plan (8,560 shares)	21	158			179
Dividends declared (\$0.76 per share)			(2,570)		(2,570)
Balance, December 31, 2013	8,482	\$11,537	\$46,082	\$305	\$66,406
Net income			7,140		7,140
Other comprehensive income				1,010	1,010
Restricted stock awards, stock incentive plan (14,009 shares)	35	(35)			—
Income tax benefit on vesting of restricted stock		21			21
Income tax benefit on disqualifying disposition of stock options exercised		7			7
Stock options exercised (927 shares)	2	(2)			—
Stock-based compensation expense		290			290
Issuance of common stock, dividend investment plan (31,904 shares)	80	620			700
Issuance of common stock, employee benefit plan (8,893 shares)	22	180			202
Dividends declared (\$0.77 per share)			(2,644)		(2,644)
Balance, December 31, 2014	8,621	\$12,618	\$50,578	\$1,315	\$73,132
Net income			6,897		6,897
Other comprehensive (loss)				(264)	(264)
Restricted stock awards, stock incentive plan (14,363 shares)	36	(36)			—
Income tax benefit on vesting of restricted stock		5			5
Stock-based compensation expense		328			328

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Issuance of common stock, dividend investment plan (32,340 shares)	81	648			729
Issuance of common stock, employee benefit plan (8,030 shares)	20	167			187
Dividends declared (\$0.80 per share)			(2,793 )		(2,793 )
Balance, December 31, 2015	8,758	\$13,730	\$54,682	\$1,051	\$78,221
See Notes to Consolidated Financial Statements					

48

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## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

## Consolidated Statements of Cash Flows

Years Ended December 31, 2015, 2014, and 2013

(dollars in thousands)

	2015	2014	2013
Cash Flows from Operating Activities			
Net income	\$6,897	\$7,140	7,158
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	843	772	803
Amortization of intangible and other assets	198	152	150
(Recovery of) Provision for loan losses	(227)	) 350	—
Provision for other real estate owned	288	—	—
(Gain) loss on foreclosure and sale of other real estate owned	(46)	) (82	) 140
Loss on the sale of premises and equipment	76	14	1
Loss on the sale of repossessed assets	—	4	—
(Gain) on the sale of securities	(124)	) (990	) (465
(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	(88)	) —	—
Stock-based compensation expense	328	290	305
Premium amortization on securities, net	210	97	120
Deferred tax expense	432	142	1,190
Changes in assets and liabilities:			
Decrease (increase) in other assets	2,085	(451	) (1,392
(Decrease) increase in other liabilities	(1,521)	) (179	) 183
Net cash provided by operating activities	\$7,164	\$7,259	\$8,193
Cash Flows from Investing Activities			
Proceeds from maturities, calls, and principal payments of securities available for sale	\$17,368	\$10,864	\$18,415
Proceeds from the sale of securities available for sale	3,653	8,546	3,987
Purchases of securities available for sale	(33,453)	) (8,693	) (26,863
Proceeds from the sale of restricted securities	1,325	284	585
Purchases of restricted securities	(413)	) (900	) —
Proceeds from the sale of bank premises and equipment	7	—	—
Purchases of bank premises and equipment	(2,875)	) (2,966	) (1,492
Proceeds from the sale of other real estate owned	1,956	597	1,167
Proceeds from the sale of repossessed assets	10	29	26
Net (increase) in loans	(26,317)	) (26,937	) (27,290
Net cash (used in) investing activities	\$(38,739)	) \$(19,176	) \$(31,465
Cash Flows from Financing Activities			
Net increase in demand deposits, money market and savings accounts	\$49,690	\$20,210	\$22,327
Net (decrease) in certificates of deposit	(2,788)	) (3,980	) (11,841
Net (decrease) in federal funds purchased and securities sold under agreements to repurchase	—	—	(10,000
Net (decrease) increase in Federal Home Loan Bank advances	(20,000)	) 17,750	(10,000
Redemption of trust preferred capital notes	(4,793)	) —	—

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Issuance of common stock, employee benefit plan	187	202	179
Stock options exercised	—	—	69
Cash dividends paid	(2,064	) (1,944	) (1,909
Net cash provided by (used in) financing activities	\$20,232	\$32,238	\$(11,175

49

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## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

## Consolidated Statements of Cash Flows (continued)

Years Ended December 31, 2015, 2014, and 2013

(dollars in thousands)

	2015	2014	2013
(Decrease) increase in cash and cash equivalents	\$(11,343	) \$20,321	\$(34,447 )
Cash and Cash Equivalents			
Beginning	34,564	14,243	48,690
Ending	\$23,221	\$34,564	\$14,243
Supplemental Disclosures of Cash Flow Information			
Cash payments for:			
Interest	\$1,442	\$1,916	\$2,704
Income taxes	\$583	\$1,985	\$2,097
Supplemental Schedule of Noncash Investing and Financing Activities:			
Unrealized (loss) gain on securities available for sale	\$(688	) \$1,392	\$(4,962 )
Change in fair value of interest rate swap	\$52	\$145	\$201
Other real estate and repossessed assets acquired in settlement of loans	\$870	\$781	\$25
Loans made to finance the sale of other real estate owned	\$200	\$148	\$—
Issuance of common stock, dividend investment plan	\$729	\$700	\$662
See Notes to Consolidated Financial Statements			



NOTE 1. Nature of Banking Activities and Significant Accounting Policies

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

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

Principles of Consolidation

The Company owns 100% of Bank of Clarke County (the “Bank”). 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.

Trust Assets

Eagle Investment Group (“EIG”), as a division of the Bank offers both a trust department and investment services. The trust services division of EIG offers a full range of personal and retirement plan services, which include serving as agent for bill paying and custody of assets, as investment manager with full authority or advisor, as trustee or co-trustee for trusts under will or under agreement, as trustee of life insurance trusts, as guardian or committee, as agent under a power of attorney, as executor or co-executor for estates, as custodian or investment advisor for individual retirement plans, and as trustee or trust advisor for corporate retirement plans such as profit sharing and 401(k) plans. The brokerage division of EIG offers a full range of investment services, which include tax-deferred annuities, IRAs and rollovers, mutual funds, retirement plans, 529 college savings plans, life insurance, long term care insurance, fixed income investing, brokerage CDs, and full service or discount brokerage services. Securities and other property held by the Eagle Investment Group in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Cash and Cash Equivalents

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

Securities

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

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

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

Loans

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



Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan fees collected and certain costs incurred related to loan originations are deferred and amortized as an adjustment to interest income over the life of the related loans. Deferred fees and costs are recorded as an adjustment to interest income using a method that approximates a constant yield. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful.

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

#### Troubled Debt Restructurings (TDR)

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a TDR. TDRs are considered impaired loans. Upon designation as a TDR, the Company evaluates the borrower's payment history, past due status and ability to make payments based on the revised terms of the loan. If a loan was accruing prior to being modified as a TDR and if the Company concludes that the borrower is able to make such payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the loan will remain on an accruing status. If a loan was on non-accrual status at the time of the TDR, the loan will remain on non-accrual status following the modification and may be returned to accrual status based on the policy for returning loans to accrual status as noted above.

#### Risks by Loan Portfolio Segments

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

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

##### Commercial Real Estate Lending

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

##### Construction and Land Development Lending

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

##### Commercial and Industrial Lending

Commercial business loans generally have more risk than residential mortgage loans, but have higher yields. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of the borrower. Commercial business loans typically are made

on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as commercial real estate, accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as residential real estate.



### Consumer Lending

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

### Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are impaired. An allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience and other qualitative factors. Other qualitative factors considered in the general component include the levels and trends in delinquencies and nonperforming loans, trends in volume and terms of loans, the effects of any changes in lending policies, the experience, ability, and depth of management, national and local economic trends and conditions, concentrations of credit, the quality of the Company's loan review system, competition and regulatory requirements. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair market value less estimated liquidation costs of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

### Bank Premises and Equipment

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

### Other Real Estate Owned

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

estimated cost to sell. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in the net expenses from foreclosed assets.

### Retirement Plans

The Company sponsors a 401(k) savings plan under which eligible employees may defer a portion of their compensation on a pretax basis. The Company also provides a match to participants in this plan, as described more fully in Note 12.

### Stock-Based Compensation Plan

During 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, as adopted, authorized the issuance of up to 500,000 shares of common stock. This plan is discussed more fully in Note 11.

### Income Taxes

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

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

### Advertising

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

### Reclassifications

Certain reclassifications have been made to the 2014 financial statements to conform to reporting for 2015. The results of the reclassification are not considered material.

### 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 and the effect on the weighted average number of shares of dilutive potential common stock.

	2015	2014	2013
Weighted average number of common shares outstanding used to calculate basic earnings per share	3,495,334	3,438,348	3,386,467
Effect of dilutive common stock	—	298	745
Weighted average number of common shares outstanding used to calculate diluted earnings per share	3,495,334	3,438,646	3,387,212

Stock options representing 0, 0, and 9,255 shares of common stock were not considered in computing diluted earnings per common share for 2015, 2014, and 2013, respectively, because they were anti-dilutive.

## Comprehensive Income

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

The components of the change in unrealized gains (losses) on securities during 2015, 2014, and 2013 were as follows:

	2015	2014	2013
Gross unrealized gain (loss)	\$ (564)	\$ 2,382	\$ (4,497)
Reclassification adjustment for realized (gain)	(124)	(990)	(465)
Net unrealized gain (loss) before taxes	(688)	1,392	(4,962)
Tax effect	234	(473)	1,687
	\$ (454)	\$ 919	\$ (3,275)

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

	Unrealized Gain (Loss) on Securities	Change in Fair Value of Interest Rate Swap	Post Retirement Benefit Plan	Total
December 31, 2013	\$ 547	\$ (286)	\$ 44	\$ 305
2014 Change	919	96	(5)	1,010
December 31, 2014	1,466	(190)	39	1,315
2015 Change	(454)	190	—	(264)
December 31, 2015	\$ 1,012	\$ —	\$ 39	\$ 1,051

## Derivative Financial Instruments

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

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



#### Use of Estimates

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

#### Stock Repurchase Program

On June 17, 2015, the Corporation renewed the stock repurchase program to repurchase up to 150,000 shares of its common stock prior to June 30, 2016. There was no repurchase activity during 2015, 2014 and 2013. The maximum number of shares that may yet be purchased under the plan as of December 31, 2015 are 134,337.

#### Recent Accounting Pronouncements

In June 2014, the FASB issued ASU No. 2014-12, "Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period". The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in "Compensation - Stock Compensation (Topic 718)", should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company does not expect the adoption of ASU 2014-12 to have a material impact on its consolidated financial statements.

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.

In November 2014, the FASB issued ASU No. 2014-16, "Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity." The amendments in ASU do not change the current criteria in U.S. GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. The amendments clarify how current U.S. GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features, including the embedded derivative feature being evaluated for bifurcation, in evaluating the nature of the host contract. Furthermore, the amendments clarify that no single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument. The

amendments in this ASU also clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (i.e., the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption, including adoption in an interim period, is permitted. The Company does not expect the adoption of ASU 2014-16 to have a material impact on its consolidated financial statements.



In January 2015, the FASB issued ASU No. 2015-01, "Income Statement-Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items." The amendments in this ASU eliminate from U.S. GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. If an event or transaction meets the criteria for extraordinary classification, an entity is required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also is required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company does not expect the adoption of ASU 2015-01 to have a material impact on its consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis." The amendments in this ASU are intended to improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). In addition to reducing the number of consolidation models from four to two, the new standard simplifies the FASB Accounting Standards Codification™ and improves current GAAP by placing more emphasis on risk of loss when determining a controlling financial interest, reducing the frequency of the application of related-party guidance when determining a controlling financial interest in a variable interest entity (VIE), and changing consolidation conclusions for public and private companies in several industries that typically make use of limited partnerships or VIEs. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. ASU 2015-02 may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. The Company does not expect the adoption of ASU 2015-02 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, "Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." The amendments in this ASU are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. The amendments in this ASU are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The Company does not expect the adoption of ASU 2015-03 to have a material impact on its consolidated financial statements.

In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of Effective Date." The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. All other entities may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities also may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, and interim reporting periods within

annual reporting periods beginning one year after the annual reporting period in which the entity first applies the guidance in ASU 2014-09. The Company does not expect the adoption of ASU 2015-14 (or ASU 2014-09) to have a material impact on its consolidated financial statements.

In August 2015, the FASB issued ASU 2015-15, "Interest - Imputation of Interest (Subtopic 835-30) - Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting)." On April 7, 2015, the FASB issued ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The guidance in ASU 2015-03 (see paragraph 835-30-45-1A) does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff stated that they would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. ASU 2015-15 adds these SEC comments to the "S" section of the Codification. The adoption of ASU 2015-15 did not have a material impact on our consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, "Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments." The amendments in ASU 2015-16 require that an acquirer recognize adjustments to estimated amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the estimated amounts, calculated as if the accounting had been completed at the acquisition date. The amendments also require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the estimated amounts had been recognized as of the acquisition date. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date with earlier application permitted for financial statements that have not been issued. The Company does not expect the adoption of ASU 2015-16 to have a material impact on its consolidated financial statements.

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.

## NOTE 2. Securities

Amortized costs and fair values of securities available for sale at December 31, 2015 and 2014 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
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
December 31, 2014 (in thousands)				
Obligations of U.S. government corporations and agencies	\$36,911	\$599	\$(299)	) \$37,211
Mortgage-backed securities	15,245	545	(11)	) 15,779
Obligations of states and political subdivisions	39,025	1,432	(47)	) 40,410
Corporate securities	761	4	—	) 765
	\$91,942	\$2,580	\$(357)	) \$94,165

Carrying amounts of restricted securities at December 31, 2015 and 2014 were as follows:

	December 31, 2015 (in thousands)	December 31, 2014
Federal Reserve Bank Stock	\$344	\$344
Federal Home Loan Bank Stock	1,412	2,324
Community Bankers' Bank Stock	140	140
	\$1,896	\$2,808

The amortized cost and fair value of securities available for sale at December 31, 2015, by contractual maturity, are shown below. Maturities may differ from contractual maturities in mortgage-backed securities because the mortgages underlying the securities may be called or repaid without any penalties.

	Amortized Cost (in thousands)	Fair Value
Due in one year or less	\$4,400	\$4,415
Due after one year through five years	30,674	31,238
Due after five years through ten years	37,569	38,367
Due after ten years	31,645	31,803
	\$104,288	\$105,823

During the twelve months ended December 31, 2015, the Company sold \$3.7 million in available for sale securities for a gross gain of \$124 thousand. During the twelve months ended December 31, 2014, the Company sold \$8.5 million in available for sale securities for a gross gain of \$990 thousand. During the twelve months ended December 31, 2013, the Company sold \$4.0 million in available for sale securities for a gross gain of \$465 thousand.



The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at December 31, 2015 and 2014 were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 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
December 31, 2014 (in thousands)						
Obligations of U.S. government corporations and agencies	\$1,997	\$1	\$21,615	\$298	\$23,612	\$299
Mortgage-backed securities	—	—	1,444	11	1,444	11
Obligations of states and political subdivisions	2,998	12	2,414	35	5,412	47
	\$4,995	\$13	\$25,473	\$344	\$30,468	\$357

Gross unrealized losses on available for sale securities included forty-five (45) and thirty-eight (38) debt securities at December 31, 2015 and December 31, 2014, respectively. The Company evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The Company's mortgage-backed securities are issued by U.S. government agencies, which guarantee payments to investors regardless of the status of the underlying mortgages. Consideration is given to the length of time and the amount of an unrealized loss, the financial condition of the issuer, and the intent and ability of the Company to retain its investment in the issuer long enough to allow for an anticipated recovery in fair value. The fair value of a security reflects its liquidity as compared to similar instruments, current market rates on similar instruments, and the creditworthiness of the issuer. Absent any change in the liquidity of a security or the creditworthiness of the issuer, prices will decline as market rates rise and vice-versa. The primary cause of the unrealized losses at December 31, 2015 and December 31, 2014 was changes in market interest rates. Since the losses can be primarily attributed to changes in market interest rates and not expected cash flows or an issuer's financial condition, the unrealized losses are deemed to be temporary. The continuing economic recession involving housing, liquidity and credit were also contributing factors to the unrealized losses on these securities at December 31, 2015 and December 31, 2014. 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 December 31, 2015 were pledged for various purposes required by law.



## NOTE 3. Loans

The composition of loans at December 31, 2015 and 2014 was as follows:

	December 31, 2015 (in thousands)	2014
Mortgage loans on real estate:		
Construction and land development	\$35,019	\$25,887
Secured by farmland	6,550	10,602
Secured by 1-4 family residential properties	229,651	224,694
Multifamily	3,975	3,016
Commercial	175,172	161,299
Loans to farmers	1,331	957
Commercial and industrial loans	29,366	28,132
Consumer installment loans	13,530	13,874
All other loans	979	1,359
Total loans (1)	\$495,573	\$469,820
Less: Allowance for loan losses	4,959	5,080
Net Loans	\$490,614	\$464,740

(1) Included in total loans were net deferred loan fees of \$103 thousand and \$26 thousand, respectively.

## NOTE 4. Allowance for Loan Losses

Changes in the allowance for loan losses for the years December 31, 2015, 2014 and 2013 were as follows:

	December 31, 2015	2014 (in thousands)	2013
Balance, beginning	\$5,080	\$5,488	\$6,577
(Recovery of) provision for loan losses	(227	) 350	—
Recoveries added to the allowance	562	725	233
Loan losses charged to the allowance	(456	) (1,483	) (1,322
Balance, ending	\$4,959	\$5,080	\$5,488

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Nonaccrual and past due loans by class at December 31, 2015 and December 31, 2014 were as follows:

December 31, 2015 (in thousands)								
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Current	Total Loans	90 or More Days Past Due Still Accruing	Nonaccrual Loans
Commercial - Non Real Estate:								
Commercial & Industrial	\$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
December 31, 2014 (in thousands)								
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Current	Total Loans	90 or More Past Due Still Accruing	Nonaccrual Loans
Commercial - Non Real Estate:								
Commercial & Industrial	\$28	\$—	\$—	\$28	\$28,104	\$ 28,132	\$—	\$ 2,106
Commercial Real Estate:								
Owner Occupied	2,191	—	—	2,191	97,516	99,707	—	2,591
Non-owner occupied	56	210	808	1,074	60,518	61,592	—	1,231
Construction and Farmland:								
Residential	—	52	—	52	5,149	5,201	—	—
Commercial	—	—	57	57	31,231	31,288	—	787

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Consumer:								
Installment	50	15	6	71	13,803	13,874	6	—
Residential:								
Equity Lines	132	41	185	358	30,763	31,121	—	331
Single family	1,243	440	644	2,327	191,246	193,573	—	3,660
Multifamily	—	—	—	—	3,016	3,016	—	—
All Other Loans	—	—	—	—	2,316	2,316	—	—
Total	\$3,700	\$758	\$1,700	\$6,158	\$463,662	\$469,820	\$6	\$10,706

Allowance for loan losses by segment at December 31, 2015, December 31, 2014 and December 31, 2013 were as follows:

	As of and for the Twelve Months Ended December 31, 2015 (in thousands)							
	Construction and Farmland	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$951	\$ 1,977	\$ 1,347	\$ 464	\$103	\$42	\$ 196	\$