

EAGLE FINANCIAL SERVICES INC  
Form 10-Q  
November 13, 2015

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

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

For the quarterly period ended September 30, 2015  
or

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

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

Commission File Number: 0-20146

EAGLE FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Virginia

(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)

22611

(Zip Code)

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

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

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

Large accelerated filer  Accelerated filer

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

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

The number of shares of the registrant's Common Stock (\$2.50 par value) outstanding as of October 31, 2015 was 3,508,831.



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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## EAGLE FINANCIAL SERVICES, INC.

## Consolidated Balance Sheets

(dollars in thousands, except share amounts)

|  | September 30,<br>2015<br>(Unaudited) | December 31,<br>2014 |
|--|--------------------------------------|----------------------|
| Assets   |                                      |                      |
| Cash and due from banks  | \$9,758                              | \$9,075              |
| Interest-bearing deposits with other institutions  | 7,183                                | 25,489               |
| Total cash and cash equivalents  | 16,941                               | 34,564               |
| Securities available for sale, at fair value   | 101,182                              | 94,165               |
| Restricted investments   | 2,321                                | 2,808                |
| Loans  | 491,216                              | 469,820              |
| Allowance for loan losses  | (5,164                               | ) (5,080             |
| Net Loans  | 486,052                              | 464,740              |
| Bank premises and equipment, net   | 20,924                               | 19,015               |
| Other real estate owned, net of allowance  | 1,848                                | 2,102                |
| Other assets   | 8,801                                | 9,436                |
| Total assets   | \$638,069                            | \$626,830            |
| Liabilities and Shareholders' Equity   |                                      |                      |
| Liabilities  |                                      |                      |
| Deposits:  |                                      |                      |
| Noninterest bearing demand deposits  | \$ 177,005                           | \$ 159,352           |
| Savings and interest bearing demand deposits   | 255,135                              | 249,305              |
| Time deposits  | 95,731                               | 95,159               |
| Total deposits   | \$527,871                            | \$503,816            |
| Federal Home Loan Bank advances  | 30,000                               | 40,000               |
| Trust preferred capital notes  | —                                    | 7,217                |
| Other liabilities  | 2,589                                | 2,665                |
| Total liabilities  | \$560,460                            | \$553,698            |
| 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, 3,508,831 including 19,401 shares of unvested restricted stock; issued and outstanding 2014, 3,463,665 including 15,151 shares of unvested restricted stock | 8,723                                | 8,621                |
| Surplus  | 13,464                               | 12,618               |
| Retained earnings  | 54,029                               | 50,578               |
| Accumulated other comprehensive income   | 1,393                                | 1,315                |
| Total shareholders' equity   | \$77,609                             | \$73,132             |
| Total liabilities and shareholders' equity   | \$638,069                            | \$626,830            |
| See Notes to Consolidated Financial Statements   |                                      |                      |



## EAGLE FINANCIAL SERVICES, INC.

## Consolidated Statements of Income (Unaudited)

(dollars in thousands, except per share amounts)

|  | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|---------|------------------------------------|----------|
|  | 2015                                | 2014    | 2015                               | 2014     |
| Interest and Dividend Income   |                                     |         |                                    |          |
| Interest and fees on loans   | \$5,540                             | \$5,397 | \$16,278                           | \$16,317 |
| Interest and dividends on securities available for sale:                               |                                     |         |                                    |          |
| Taxable interest income  | 437                                 | 458     | 1,219                              | 1,447    |
| Interest income exempt from federal income taxes                                       | 244                                 | 270     | 733                                | 834      |
| Dividends  | 42                                  | 126     | 75                                 | 197      |
| Interest on deposits with other institutions   | 2                                   | 2       | 19                                 | 4        |
| Total interest and dividend income   | \$6,265                             | \$6,253 | \$18,324                           | \$18,799 |
| Interest Expense   |                                     |         |                                    |          |
| Interest on deposits   | 185                                 | 241     | 551                                | 730      |
| Interest on federal funds purchased and securities sold under agreements to repurchase | 9                                   | —       | 10                                 | 20       |
| Interest on Federal Home Loan Bank advances  | 69                                  | 159     | 269                                | 476      |
| Interest on trust preferred capital notes  | 12                                  | 33      | 78                                 | 98       |
| Interest on interest rate swap   | 46                                  | 47      | 137                                | 139      |
| Total interest expense   | \$321                               | \$480   | \$1,045                            | \$1,463  |
| Net interest income  | \$5,944                             | \$5,773 | \$17,279                           | \$17,336 |
| (Recovery Of) Provision For Loan Losses  | (410)                               | ) —     | 23                                 | —        |
| Net interest income after (recovery of) provision for loan losses                      | \$6,354                             | \$5,773 | \$17,256                           | \$17,336 |
| Noninterest Income   |                                     |         |                                    |          |
| Income from fiduciary activities   | \$319                               | \$212   | \$1,103                            | \$873    |
| Service charges on deposit accounts  | 329                                 | 332     | 926                                | 984      |
| Other service charges and fees   | 919                                 | 827     | 2,605                              | 2,307    |
| Gain on sale of securities   | 20                                  | 87      | 116                                | 93       |
| Gain on redemption of trust preferred capital notes                                    | 2,424                               | —       | 2,424                              | —        |
| Other operating (loss) income  | (181)                               | ) 15    | (71)                               | ) 127    |
| Total noninterest income   | \$3,830                             | \$1,473 | \$7,103                            | \$4,384  |
| Noninterest Expenses   |                                     |         |                                    |          |
| Salaries and employee benefits   | \$3,090                             | \$3,017 | \$9,197                            | \$8,768  |
| Occupancy expenses   | 394                                 | 319     | 1,176                              | 963      |
| Equipment expenses   | 312                                 | 197     | 718                                | 546      |
| Advertising and marketing expenses   | 155                                 | 159     | 458                                | 417      |
| Stationery and supplies  | 67                                  | 74      | 179                                | 238      |
| ATM network fees   | 246                                 | 174     | 595                                | 532      |
| Other real estate owned expense  | 63                                  | 4       | 83                                 | 14       |
| (Gain) loss on the sale of other real estate owned                                     | (11)                                | ) 14    | 81                                 | (3)      |
| FDIC assessment  | 108                                 | 94      | 319                                | 261      |
| Computer software expense  | 134                                 | 252     | 547                                | 664      |
| Bank franchise tax   | 131                                 | 123     | 374                                | 342      |
| Professional fees  | 211                                 | 290     | 714                                | 761      |
| Cost to terminate operating lease  | —                                   | —       | 520                                | —        |
| Other operating expenses   | 618                                 | 616     | 1,746                              | 1,639    |

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|                                      |         |         |          |          |
|--------------------------------------|---------|---------|----------|----------|
| Total noninterest expenses           | \$5,518 | \$5,333 | \$16,707 | \$15,142 |
| Income before income taxes           | \$4,666 | \$1,913 | \$7,652  | \$6,578  |
| Income Tax Expense                   | 1,377   | 528     | 2,110    | 1,872    |
| Net income                           | \$3,289 | \$1,385 | \$5,542  | \$4,706  |
| Earnings Per Share                   |         |         |          |          |
| Net income per common share, basic   | \$0.94  | \$0.40  | \$1.59   | \$1.37   |
| Net income per common share, diluted | \$0.94  | \$0.40  | \$1.59   | \$1.37   |

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See Notes to Consolidated Financial Statements

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

|   | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|---|-------------------------------------|---------|------------------------------------|---------|
|   | 2015                                | 2014    | 2015                               | 2014    |
| Net income  | \$3,289                             | \$1,385 | \$5,542                            | \$4,706 |
| Other comprehensive income (loss):  |                                     |         |                                    |         |
| Unrealized gain (loss) on available for sale securities, net of deferred income tax expense (benefit) of \$259 and (\$39) for the three months ended, respectively and (\$58) and \$588 for the nine months ended, respectively | 503                                 | (76     | ) (112                             | ) 1,143 |
| Change in fair value of interest rate swap, net of deferred income tax expense of \$81 and \$22 for the three months ended, respectively and \$99 and \$41 for the nine months ended, respectively                              | 156                                 | 41      | 190                                | 79      |
| Total other comprehensive income (loss)   | 659                                 | (35     | ) 78                               | 1,222   |
| Total comprehensive income  | \$3,948                             | \$1,350 | \$5,620                            | \$5,928 |
| See Notes to Consolidated Financial Statements  |                                     |         |                                    |         |

## EAGLE FINANCIAL SERVICES, INC.

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

(dollars in thousands, except share amounts)

|   | Common<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total    |
|---|-----------------|----------|----------------------|---|----------|
| Balance, December 31, 2013  | \$8,482         | \$11,537 | \$46,082             | \$ 305  | \$66,406 |
| Net income  |                 |          | 4,706                |   | 4,706    |
| Other comprehensive income  |                 |          |                      | 1,222   | 1,222    |
| Vesting of restricted stock awards, stock<br>incentive plan (10,009 shares) | 25              | (25 )    |                      |   | —        |
| Income tax benefit on vesting of<br>restricted stock                        |                 | 11       |                      |   | 11       |
| Stock options exercised (927 shares)  | 2               | (2 )     |                      |   | —        |
| Stock-based compensation expense  |                 | 173      |                      |   | 173      |
| Issuance of common stock, dividend<br>investment plan (23,473 shares)       | 59              | 456      |                      |   | 515      |
| Issuance of common stock, employee<br>benefit plan (7,995 shares)           | 20              | 162      |                      |   | 182      |
| Dividends declared (\$0.57 per share)                                       |                 |          | (1,954 )             |   | (1,954 ) |
| Balance, September 30, 2014   | \$8,588         | \$12,312 | \$48,834             | \$ 1,527  | \$71,261 |
| Balance, December 31, 2014  | \$8,621         | \$12,618 | \$50,578             | \$ 1,315  | 73,132   |
| Net income  |                 |          | 5,542                |   | 5,542    |
| Other comprehensive income  |                 |          |                      | 78  | 78       |
| Vesting of restricted stock awards, stock<br>incentive plan (9,363 shares)  | 23              | (23 )    |                      |   | —        |
| Income tax benefit on vesting of<br>restricted stock                        |                 | 4        |                      |   | 4        |
| Stock-based compensation expense  |                 | 227      |                      |   | 227      |
| Issuance of common stock, dividend<br>investment plan (24,439 shares)       | 61              | 490      |                      |   | 551      |
| Issuance of common stock, employee<br>benefit plan (7,114 shares)           | 18              | 148      |                      |   | 166      |
| Dividends declared (\$0.60 per share)                                       |                 |          | (2,091 )             |   | (2,091 ) |
| Balance, September 30, 2015   | \$8,723         | \$13,464 | \$54,029             | \$ 1,393  | \$77,609 |
| See Notes to Consolidated Financial Statements                              |                 |          |                      |   |          |

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

|  | Nine Months Ended<br>September 30, |             |
|--|------------------------------------|-------------|
|  | 2015                               | 2014        |
| Cash Flows from Operating Activities   |                                    |             |
| Net income   | \$5,542                            | \$4,706     |
| Adjustments to reconcile net income to net cash provided by operating activities:                  |                                    |             |
| Depreciation   | 619                                | 587         |
| Amortization of intangible and other assets  | 154                                | 117         |
| Provision for loan losses  | 23                                 | —           |
| Provision for other real estate owned  | 53                                 | —           |
| Loss (gain) on the sale of other real estate owned   | 81                                 | (3          |
| (Gain) on the sale of premises and equipment   | (5                                 | ) —         |
| Loss on the sale of repossessed assets   | —                                  | 5           |
| (Gain) on the sale of securities   | (116                               | ) (93       |
| (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   | (30                                | ) —         |
| Stock-based compensation expense   | 227                                | 173         |
| Premium amortization on securities, net  | 191                                | 88          |
| Changes in assets and liabilities:   |                                    |             |
| Decrease (increase) in other assets  | 437                                | (812        |
| Increase (decrease) in other liabilities   | 6                                  | (262        |
| Net cash provided by operating activities  | \$4,995                            | \$4,506     |
| Cash Flows from Investing Activities   |                                    |             |
| Proceeds from maturities and principal payments of securities available for sale                   | \$10,641                           | \$9,264     |
| Proceeds from the sale of securities available for sale  | 3,424                              | 1,129       |
| Purchases of securities available for sale   | (21,327                            | ) (5,081    |
| Proceeds from the sale of restricted investments   | 900                                | 284         |
| Purchases of restricted investments  | (413                               | ) (450      |
| Purchases of bank premises and equipment   | (2,528                             | ) (2,272    |
| Proceeds from the sale of other real estate owned  | 856                                | 685         |
| Proceeds from the sale of bank premises and equipment  | 5                                  | —           |
| Proceeds from the sale of repossessed assets   | 10                                 | 26          |
| Net (increase) in loans  | (22,074                            | ) (21,039   |
| Net cash (used in) investing activities  | \$(30,506                          | ) \$(17,454 |
| Cash Flows from Financing Activities   |                                    |             |
| Net increase in noninterest bearing demand deposits, savings, and interest bearing demand deposits | \$23,483                           | \$12,250    |
| Net increase (decrease) in time deposits   | 572                                | (4,700      |
| Net (decrease) increase in Federal Home Loan Bank advances   | (10,000                            | ) 7,750     |
| Redemption of trust preferred capital notes  | (4,793                             | ) —         |
| Issuance of common stock, employee benefit plan  | 166                                | 182         |
| Cash dividends paid  | (1,540                             | ) (1,439    |
| Net cash provided by financing activities  | \$7,888                            | \$14,043    |



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

|  | Nine Months Ended<br>September 30, |            |
|--|------------------------------------|------------|
|  | 2015                               | 2014       |
| (Decrease) increase in cash and cash equivalents                         | \$ (17,623                         | ) \$ 1,095 |
| Cash and Cash Equivalents  |                                    |            |
| Beginning  | 34,564                             | 14,243     |
| Ending   | \$ 16,941                          | \$ 15,338  |
| Supplemental Disclosures of Cash Flow Information                        |                                    |            |
| Cash payments for:   |                                    |            |
| Interest   | \$ 1,141                           | \$ 1,474   |
| Income taxes   | \$ 583                             | \$ 1,985   |
| Supplemental Schedule of Noncash Investing and Financing Activities:     |                                    |            |
| Unrealized (loss) gain on securities available for sale                  | \$ (170                            | ) \$ 1,731 |
| Change in fair value of interest rate swap                               | \$ 52                              | \$ 120     |
| Other real estate and repossessed assets acquired in settlement of loans | \$ 739                             | \$ 680     |
| Issuance of common stock, dividend investment plan                       | \$ 551                             | \$ 515     |

EAGLE FINANCIAL SERVICES, INC.

Notes to Consolidated Financial Statements (Unaudited)

September 30, 2015

NOTE 1. General

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

In the opinion of management, the accompanying financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position at September 30, 2015 and December 31, 2014, the results of operations for the three and nine months ended September 30, 2015 and 2014, and cash flows for the nine months ended September 30, 2015 and 2014. The results of operations for the three and nine months ended September 30, 2015 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 (the "2014 Form 10-K").

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

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

NOTE 2. Stock-Based Compensation Plan

During 2014, the Company's shareholders approved a stock incentive plan which allows key employees and directors to increase their personal financial interest in the Company. This plan permits the issuance of incentive stock options and non-qualified stock options and the award of stock appreciation rights, common stock, restricted stock, and phantom stock. The plan authorizes the issuance of up to 500,000 shares of common stock.

The Company periodically grants Restricted Stock to its directors and executive officers. Restricted Stock provides grantees with rights to shares of common stock upon completion of a service period or achievement of Company performance measures. During the restriction period, all shares are considered outstanding and dividends are paid to the grantee. In general, outside directors are periodically granted restricted shares which vest over a period of less than 9 months. Beginning during 2006, executive officers were granted restricted shares which vest over a 3 year service period and restricted shares which vest based on meeting annual performance measures. The Company recognizes compensation expense over the restricted period. As of September 30, 2015, there was \$138 thousand of unrecognized compensation cost related to nonvested restricted stock.

The following table presents Restricted Stock activity for the nine months ended September 30, 2015 and 2014:

| Nine Months Ended<br>September 30,<br>2015 |                                   | 2014   |                                   |
|--|-----------------------------------|--------|-----------------------------------|
| Shares                                     | Weighted<br>Average<br>Grant Date | Shares | Weighted<br>Average<br>Grant Date |

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|                                |        | Fair Value |         | Fair Value |
|--------------------------------|--------|------------|---------|------------|
| Nonvested, beginning of period | 15,151 | \$22.27    | 17,050  | \$19.92    |
| Granted                        | 14,650 | 23.85      | 14,900  | 23.50      |
| Vested                         | (9,363 | ) 21.80    | (10,009 | ) 19.65    |
| Forfeited                      | (1,037 | ) 23.50    | (2,790  | ) 22.11    |
| Nonvested, end of period       | 19,401 | \$23.63    | 19,151  | \$22.53    |

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## NOTE 3. Earnings Per Common Share

Basic earnings per share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Nonvested restricted shares are included in basic earnings per share because of dividend participation and voting rights. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. The number of potential common shares is determined using the treasury method.

The following table shows the weighted average number of shares used in computing earnings per share for the three and nine months ended September 30, 2015 and 2014 and the effect on the weighted average number of shares of dilutive potential common stock. During 2015 and 2014, there were no potentially dilutive securities outstanding.

|  | Three Months Ended |           | Nine Months Ended |           |
|--|--------------------|-----------|-------------------|-----------|
|  | September 30,      |           | September 30,     |           |
|  | 2015               | 2014      | 2015              | 2014      |
| Average number of common shares outstanding  | 3,503,412          | 3,451,041 | 3,489,388         | 3,431,356 |
| Effect of dilutive common stock  | —                  | —         | —                 | —         |
| Average number of common shares outstanding used to calculate diluted earnings per share | 3,503,412          | 3,451,041 | 3,489,388         | 3,431,356 |

## NOTE 4. Securities

Amortized costs and fair values of securities available for sale at September 30, 2015 and December 31, 2014 were as follows:

|  | Amortized<br>Cost                    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair<br>Value |
|--|--------------------------------------|------------------------------|---------------------------------|---------------|
|  | September 30, 2015<br>(in thousands) |                              |                                 |               |
| Obligations of U.S. government corporations and agencies | \$38,808                             | \$625                        | \$(48)                          | ) \$39,385    |
| Mortgage-backed securities                               | 21,111                               | 384                          | (83)                            | ) 21,412      |
| Obligations of states and political subdivisions         | 39,210                               | 1,195                        | (20)                            | ) 40,385      |
|  | \$99,129                             | \$2,204                      | \$(151)                         | ) \$101,182   |
|  | December 31, 2014<br>(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    |

During the nine months ended September 30, 2015, the Company received proceeds of \$3.4 million on sales of available for sale securities for a gross gain of \$116 thousand. There were no losses on the sale of available for sale securities during the nine months ended September 30, 2015. During the nine months ended September 30, 2014, the Company sold \$1.1 million of available for sale securities for a gross gain of \$93 thousand. There were no losses on the sale of available for sale securities during the nine months ended September 30, 2014.





The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at September 30, 2015 and December 31, 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 |
|  | September 30, 2015<br>(in thousands) |                         |                   |                         |            |                         |
| Obligations of U.S. government corporations and agencies | \$11,877                             | \$39                    | \$1,991           | \$9                     | \$13,868   | \$48                    |
| Mortgage-backed securities                               | 7,313                                | 68                      | 1,190             | 15                      | 8,503      | 83                      |
| Obligations of states and political subdivisions         | 3,530                                | 18                      | 1,012             | 2                       | 4,542      | 20                      |
|  | \$22,720                             | \$125                   | \$4,193           | \$26                    | \$26,913   | \$151                   |
|  | December 31, 2014<br>(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 twenty-nine (29) and thirty-eight (38) debt securities at September 30, 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. Consideration is given to the length of time and the amount of an unrealized loss, the financial condition of the issuer, and the intent and ability of the Company to retain its investment in the issuer long enough to allow for an anticipated recovery in fair value. The fair value of a security reflects its liquidity as compared to similar instruments, current market rates on similar instruments, and the creditworthiness of the issuer. Absent any change in the liquidity of a security or the creditworthiness of the issuer, prices will decline as market rates rise and vice-versa. The primary cause of the unrealized losses at September 30, 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 a contributing factor to the unrealized losses on these securities at September 30, 2015 and December 31, 2014. The Company's mortgage-backed securities are issued by U.S. government agencies, which guarantee payments to investors regardless of the status of the underlying mortgages. The Company monitors the financial condition of these issuers continuously and will record other-than-temporary impairment if the recovery of value is unlikely.

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

securities.

Securities having a carrying value of \$3.4 million at September 30, 2015 were pledged to secure securities sold under agreements to repurchase and other purposes required by law.

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The composition of restricted investments at September 30, 2015 and December 31, 2014 was as follows:

|                               | September 30,<br>2015<br>(in thousands) | December 31,<br>2014 |
|-------------------------------|---|----------------------|
| Federal Reserve Bank Stock    | \$344                                   | \$344                |
| Federal Home Loan Bank Stock  | 1,837                                   | 2,324                |
| Community Bankers' Bank Stock | 140                                     | 140                  |
|                               | \$2,321                                 | \$2,808              |

NOTE 5. Allowance for Loan Losses

Changes in the allowance for loan losses for the nine months ended September 30, 2015 and 2014 and the year ended December 31, 2014 were as follows:

|  | Nine Months Ended<br>September 30,<br>2015 | Year Ended<br>December 31,<br>2014<br>(in thousands) | Nine Months Ended<br>September 30,<br>2014 |
|--|--|--|--|
| Balance, beginning                     | \$5,080                                    | \$5,488  | \$5,488                                    |
| Provision charged to operating expense | 23   | 350  | —  |
| Recoveries added to the allowance      | 499  | 725  | 614  |
| Loan losses charged to the allowance   | (438                                       | ) (1,483   | ) (515                                     |
| Balance, ending                        | \$5,164                                    | \$5,080  | \$5,587                                    |

Nonaccrual and past due loans by class at September 30, 2015 and December 31, 2014 were as follows:

|                                  | September 30, 2015<br>(in thousands) |                             |                                |       | Total Past<br>Due | Current  | Total Loans | 90 or<br>More<br>Days Past<br>Due Still<br>Accruing | Nonaccrual<br>Loans |
|----------------------------------|--------------------------------------|-----------------------------|--------------------------------|-------|-------------------|----------|-------------|---|---------------------|
|                                  | 30 - 59<br>Days<br>Past Due          | 60 - 89<br>Days<br>Past Due | 90 or More<br>Days<br>Past Due |       |                   |          |             |   |                     |
| Commercial - Non<br>Real Estate: |                                      |                             |                                |       |                   |          |             |   |                     |
| Commercial &<br>Industrial       | \$108                                | \$—                         | \$—                            | \$108 | \$27,310          | \$27,418 | \$—         | \$560   |                     |
| Commercial Real<br>Estate:       |                                      |                             |                                |       |                   |          |             |   |                     |
| Owner Occupied                   | 871                                  | —                           | —                              | 871   | 108,604           | 109,475  | —           | 1,712   |                     |
| Non-owner occupied               | 907                                  | —                           | 766                            | 1,673 | 61,784            | 63,457   | —           | 971   |                     |
| Construction and<br>Farmland:    |                                      |                             |                                |       |                   |          |             |   |                     |
| Residential                      | —                                    | 249                         | 140                            | 389   | 8,205             | 8,594    | —           | 140   |                     |
| Commercial                       | —                                    | 53                          | —                              | 53    | 32,314            | 32,367   | —           | 326   |                     |
| Consumer:                        |                                      |                             |                                |       |                   |          |             |   |                     |
| Installment                      | 58                                   | 1                           | 1                              | 60    | 13,556            | 13,616   | 1           | —   |                     |
| Residential:                     |                                      |                             |                                |       |                   |          |             |   |                     |

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|                 |         |       |         |         |           |           |     |         |
|-----------------|---------|-------|---------|---------|-----------|-----------|-----|---------|
| Equity Lines    | 3,423   | 6     | —       | 3,429   | 31,270    | 34,699    | —   | 281     |
| Single family   | 2,397   | —     | 733     | 3,130   | 192,830   | 195,960   | —   | 1,683   |
| Multifamily     | —       | —     | —       | —       | 3,453     | 3,453     | —   | —       |
| All Other Loans | —       | —     | —       | —       | 2,177     | 2,177     | —   | —       |
| Total           | \$7,764 | \$309 | \$1,640 | \$9,713 | \$481,503 | \$491,216 | \$1 | \$5,673 |

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December 31, 2014

(in thousands)

|  | 30 - 59<br>Days<br>Past Due | 60 - 89<br>Days<br>Past Due | 90 or More<br>Days<br>Past Due | Total Past<br>Due | Current   | Total Loans | 90 or More<br>Past Due<br>Still<br>Accruing | Nonaccrual<br>Loans |
|--|-----------------------------|-----------------------------|--------------------------------|-------------------|-----------|-------------|---|---------------------|
| Commercial - Non<br>Real Estate:<br>Commercial &<br>Industrial | \$28                        | \$—                         | \$—                            | \$28              | \$28,104  | \$ 28,132   | \$—   | \$ 2,106            |
| Commercial Real<br>Estate:<br>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<br>Farmland:<br>Residential                   | —                           | 52                          | —                              | 52                | 5,149     | 5,201       | —   | —                   |
| Commercial   | —                           | —                           | 57                             | 57                | 31,231    | 31,288      | —   | 787                 |
| Consumer:<br>Installment                                       | 50                          | 15                          | 6                              | 71                | 13,803    | 13,874      | 6   | —                   |
| Residential:<br>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 September 30, 2015 and December 31, 2014 were as follows:

As of and for the Nine Months Ended

September 30, 2015

(in thousands)

|  | Construction<br>and Farmland | Residential | Commercial<br>Real Estate | Commercial<br>- Non Real<br>Estate | Consumer | All Other<br>Loans | Unallocated | Total   |
|--|------------------------------|-------------|---------------------------|------------------------------------|----------|--------------------|-------------|---------|
| Allowance for credit<br>losses:                                |                              |             |                           |                                    |          |                    |             |         |
| Beginning Balance  | \$951                        | \$1,977     | \$1,347                   | \$464                              | \$103    | \$42               | \$196       | \$5,080 |
| Charge-Offs  | (166)                        | (152)       | (47)                      | —                                  | (54)     | (19)               | —           | (438)   |
| Recoveries   | 63                           | 157         | 60                        | 179                                | 26       | 14                 | —           | 499     |
| Provision  | 85                           | 102         | 89                        | (307)                              | 27       | 13                 | 14          | 23      |
| Ending balance   | \$933                        | \$2,084     | \$1,449                   | \$336                              | \$102    | \$50               | \$210       | \$5,164 |
| Ending balance:<br>Individually<br>evaluated for<br>impairment | \$138                        | \$343       | \$102                     | \$8                                | \$—      | \$—                | \$—         | \$591   |
| Ending balance:<br>collectively<br>evaluated for               | \$795                        | \$1,741     | \$1,347                   | \$328                              | \$102    | \$50               | \$210       | \$4,573 |

|                |          |           |           |          |          |         |     |           |
|----------------|----------|-----------|-----------|----------|----------|---------|-----|-----------|
| impairment     |          |           |           |          |          |         |     |           |
| Loans:         |          |           |           |          |          |         |     |           |
| Ending balance | \$40,961 | \$234,112 | \$172,932 | \$27,418 | \$13,616 | \$2,177 | \$— | \$491,216 |
| Ending balance |          |           |           |          |          |         |     |           |
| individually   |          |           |           |          |          |         |     |           |
| evaluated for  | \$2,266  | \$7,052   | \$4,746   | \$953    | \$—      | \$—     | \$— | \$15,017  |
| impairment     |          |           |           |          |          |         |     |           |
| Ending balance |          |           |           |          |          |         |     |           |
| collectively   |          |           |           |          |          |         |     |           |
| evaluated for  | \$38,695 | \$227,060 | \$168,186 | \$26,465 | \$13,616 | \$2,177 | \$— | \$476,199 |
| impairment     |          |           |           |          |          |         |     |           |

As of and for the Twelve Months Ended  
December 31, 2014  
(in thousands)

|  | Construction<br>and Farmland | Residential | Commercial<br>Real Estate | Commercial<br>- Non Real<br>Estate | Consumer | All Other<br>Loans | Unallocated | Total     |
|--|------------------------------|-------------|---------------------------|------------------------------------|----------|--------------------|-------------|-----------|
| Allowance for credit losses:                         |                              |             |                           |                                    |          |                    |             |           |
| Beginning Balance                                    | \$1,032                      | \$2,225     | \$1,337                   | \$555                              | \$102    | \$82               | \$155       | \$5,488   |
| Charge-Offs  | (482)                        | (808)       | (83)                      | —                                  | (86)     | (24)               | —           | (1,483)   |
| Recoveries   | 26                           | 63          | 381                       | 164                                | 87       | 4                  | —           | 725       |
| Provision  | 375                          | 497         | (288)                     | (255)                              | —        | (20)               | 41          | 350       |
| Ending balance                                       | \$951                        | \$1,977     | \$1,347                   | \$464                              | \$103    | \$42               | \$196       | \$5,080   |
| Ending balance:                                      |                              |             |                           |                                    |          |                    |             |           |
| Individually evaluated for impairment                | \$93                         | \$303       | \$203                     | \$44                               | \$—      | \$—                | \$—         | \$643     |
| Ending balance:                                      |                              |             |                           |                                    |          |                    |             |           |
| collectively evaluated for impairment                | \$858                        | \$1,674     | \$1,144                   | \$420                              | \$103    | \$42               | \$196       | \$4,437   |
| Loans:   |                              |             |                           |                                    |          |                    |             |           |
| Ending balance                                       | \$36,489                     | \$227,710   | \$161,299                 | \$28,132                           | \$13,874 | \$2,316            | \$—         | \$469,820 |
| Ending balance individually evaluated for impairment | \$2,665                      | \$6,550     | \$5,716                   | \$2,106                            | \$—      | \$—                | \$—         | \$17,037  |
| Ending balance collectively evaluated for impairment | \$33,824                     | \$221,160   | \$155,583                 | \$26,026                           | \$13,874 | \$2,316            | \$—         | \$452,783 |



Impaired loans by class as of and for the periods ended September 30, 2015 and December 31, 2014 were as follows:

|                               | As of and for the Nine Months Ended<br>September 30, 2015<br>(in thousands) |                               |                      |                                   |                                  |
|-------------------------------|---|-------------------------------|----------------------|-----------------------------------|----------------------------------|
|                               | Unpaid<br>Principal<br>Balance  | Recorded<br>Investment<br>(1) | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| With no related allowance:    |   |                               |                      |                                   |                                  |
| Commercial - Non Real Estate: |   |                               |                      |                                   |                                  |
| Commercial & Industrial       | \$1,081   | \$881                         | \$—                  | \$1,075                           | \$3                              |
| Commercial Real Estate:       |   |                               |                      |                                   |                                  |
| Owner Occupied                | 2,439   | 2,273                         | —                    | 2,375                             | 22                               |
| Non-owner occupied            | 1,242   | 1,176                         | —                    | 1,183                             | —                                |
| Construction and Farmland:    |   |                               |                      |                                   |                                  |
| Residential                   | 140   | 140                           | —                    | 134                               | 3                                |
| Commercial                    | 1,367   | 1,348                         | —                    | 1,372                             | 34                               |
| Residential:                  |   |                               |                      |                                   |                                  |
| Equity lines                  | 399   | 219                           | —                    | 221                               | 1                                |
| Single family                 | 4,663   | 4,550                         | —                    | 4,701                             | 104                              |
| Multifamily                   | —   | —                             | —                    | —                                 | —                                |
| Other Loans                   | —   | —                             | —                    | —                                 | —                                |
|                               | \$11,331  | \$10,587                      | \$—                  | \$11,061                          | \$167                            |
| With an allowance recorded:   |   |                               |                      |                                   |                                  |
| Commercial - Non Real Estate: |   |                               |                      |                                   |                                  |
| Commercial & Industrial       | \$73  | \$73                          | \$8                  | \$81                              | \$13                             |
| Commercial Real Estate:       |   |                               |                      |                                   |                                  |
| Owner Occupied                | —   | —                             | —                    | —                                 | —                                |
| Non-owner occupied            | 1,299   | 1,303                         | 102                  | 1,315                             | 52                               |
| Construction and Farmland:    |   |                               |                      |                                   |                                  |
| Residential                   | —   | —                             | —                    | —                                 | —                                |
| Commercial                    | 778   | 781                           | 138                  | 809                               | 24                               |
| Residential:                  |   |                               |                      |                                   |                                  |
| Equity lines                  | 304   | 148                           | 76                   | 149                               | 2                                |
| Single family                 | 2,162   | 2,152                         | 267                  | 2,166                             | 31                               |
| Multifamily                   | —   | —                             | —                    | —                                 | —                                |
| Other Loans                   | —   | —                             | —                    | —                                 | —                                |
|                               | \$4,616   | \$4,457                       | \$591                | \$4,520                           | \$122                            |
| Total:                        |   |                               |                      |                                   |                                  |
| Commercial                    | \$1,154   | \$954                         | \$8                  | \$1,156                           | \$16                             |
| Commercial Real Estate        | 4,980   | 4,752                         | 102                  | 4,873                             | 74                               |
| Construction and Farmland     | 2,285   | 2,269                         | 138                  | 2,315                             | 61                               |
| Residential                   | 7,528   | 7,069                         | 343                  | 7,237                             | 138                              |
| Other                         | —   | —                             | —                    | —                                 | —                                |
| Total                         | \$15,947  | \$15,044                      | \$591                | \$15,581                          | \$289                            |

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



|                               | As of and for the Twelve Months End<br>December 31, 2014<br>(in thousands) |                               |                      |                                   |                                  |
|-------------------------------|--|-------------------------------|----------------------|-----------------------------------|----------------------------------|
|                               | Unpaid<br>Principal<br>Balance   | Recorded<br>Investment<br>(1) | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| With no related allowance:    |  |                               |                      |                                   |                                  |
| Commercial - Non Real Estate: |  |                               |                      |                                   |                                  |
| Commercial & Industrial       | \$2,159  | \$2,013                       | \$—                  | \$2,256                           | \$19                             |
| Commercial Real Estate:       |  |                               |                      |                                   |                                  |
| Owner Occupied                | 2,824  | 2,473                         | —                    | 2,857                             | 48                               |
| Non-owner occupied            | 2,675  | 2,560                         | —                    | 2,796                             | 86                               |
| Construction and Farmland:    |  |                               |                      |                                   |                                  |
| Residential                   | —  | —                             | —                    | —                                 | —                                |
| Commercial                    | 2,319  | 2,319                         | —                    | 2,362                             | 68                               |
| Residential:                  |  |                               |                      |                                   |                                  |
| Equity lines                  | 252  | 78                            | —                    | 252                               | —                                |
| Single family                 | 5,634  | 5,218                         | —                    | 5,719                             | 149                              |
| Multifamily                   | —  | —                             | —                    | —                                 | —                                |
| Other Loans                   | —  | —                             | —                    | —                                 | —                                |
|                               | \$15,863   | \$14,661                      | \$—                  | \$16,242                          | \$370                            |
| With an allowance recorded:   |  |                               |                      |                                   |                                  |
| Commercial - Non Real Estate: |  |                               |                      |                                   |                                  |
| Commercial & Industrial       | \$289  | \$94                          | \$44                 | \$289                             | \$—                              |
| Commercial Real Estate:       |  |                               |                      |                                   |                                  |
| Owner Occupied                | 689  | 689                           | 203                  | 704                               | 33                               |
| Non-owner occupied            | —  | —                             | —                    | —                                 | —                                |
| Construction and Farmland:    |  |                               |                      |                                   |                                  |
| Residential                   | —  | —                             | —                    | —                                 | —                                |
| Commercial                    | 385  | 350                           | 93                   | 393                               | 5                                |
| Residential:                  |  |                               |                      |                                   |                                  |
| Equity lines                  | 403  | 253                           | 95                   | 403                               | 5                                |
| Single family                 | 1,007  | 1,008                         | 208                  | 1,020                             | 41                               |
| Multifamily                   | —  | —                             | —                    | —                                 | —                                |
| Other Loans                   | —  | —                             | —                    | —                                 | —                                |
|                               | \$2,773  | \$2,394                       | \$643                | \$2,809                           | \$84                             |
| Total:                        |  |                               |                      |                                   |                                  |
| Commercial                    | \$2,448  | \$2,107                       | \$44                 | \$2,545                           | \$19                             |
| Commercial Real Estate        | 6,188  | 5,722                         | 203                  | 6,357                             | 167                              |
| Construction and Farmland     | 2,704  | 2,669                         | 93                   | 2,755                             | 73                               |
| Residential                   | 7,296  | 6,557                         | 303                  | 7,394                             | 195                              |
| Other                         | —  | —                             | —                    | —                                 | —                                |
| Total                         | \$18,636   | \$17,055                      | \$643                | \$19,051                          | \$454                            |

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

The average recorded investment of impaired loans for the three months ended September 30, 2015 was \$15.3 million. The interest income recognized on impaired loans for the three months ended September 30, 2015 was \$94 thousand.



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

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

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

Credit quality information by class at September 30, 2015 and December 31, 2014 was as follows:

| INTERNAL RISK<br>RATING GRADES   | As of<br>September 30, 2015<br>(in thousands) |                   |                    |             |          |      | Total    |
|----------------------------------|---|-------------------|--------------------|-------------|----------|------|----------|
|                                  | Pass  | Pass<br>Monitored | Special<br>Mention | Substandard | Doubtful | Loss |          |
| Commercial - Non Real<br>Estate: |   |                   |                    |             |          |      |          |
| Commercial & Industrial          | \$24,387                                      | \$2,098           | \$350              | \$459       | \$124    | \$—  | \$27,418 |
| Commercial Real Estate:          |   |                   |                    |             |          |      |          |
| Owner Occupied                   | 90,723  | 13,543            | 3,145              | 1,048       | 1,016    | —    | 109,475  |
| Non-owner occupied               | 41,932  | 19,763            | —                  | 1,762       | —        | —    | 63,457   |
| Construction and<br>Farmland:    |   |                   |                    |             |          |      |          |

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|                 |           |          |         |          |         |     |           |
|-----------------|-----------|----------|---------|----------|---------|-----|-----------|
| Residential     | 8,454     | —        | —       | 140      | —       | —   | 8,594     |
| Commercial      | 19,334    | 11,447   | 73      | 1,513    | —       | —   | 32,367    |
| Residential:    |           |          |         |          |         |     |           |
| Equity Lines    | 30,414    | 3,935    | 70      | 146      | 134     | —   | 34,699    |
| Single family   | 169,489   | 20,652   | 436     | 4,950    | 433     | —   | 195,960   |
| Multifamily     | 3,453     | —        | —       | —        | —       | —   | 3,453     |
| All other loans | 2,128     | 49       | —       | —        | —       | —   | 2,177     |
| Total           | \$390,314 | \$71,487 | \$4,074 | \$10,018 | \$1,707 | \$— | \$477,600 |

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| Consumer Credit Exposure by Payment Activity |           |                   |                    |             | Performing | Nonperforming |           |
|--|-----------|-------------------|--------------------|-------------|------------|---------------|-----------|
| As of<br>December 31, 2014<br>(in thousands) |           |                   |                    |             | \$13,556   | \$60          |           |
| INTERNAL RISK<br>RATING GRADES               | Pass      | Pass<br>Monitored | Special<br>Mention | Substandard | Doubtful   | Loss          | Total     |
| Commercial - Non Real<br>Estate:             |           |                   |                    |             |            |               |           |
| Commercial & Industrial                      | \$24,579  | \$1,775           | \$21               | \$701       | \$1,056    | \$—           | \$28,132  |
| Commercial Real Estate:                      |           |                   |                    |             |            |               |           |
| Owner Occupied                               | 77,979    | 17,401            | —                  | 3,189       | 1,138      | —             | 99,707    |
| Non-owner occupied                           | 42,630    | 14,779            | 1,402              | 2,733       | 48         | —             | 61,592    |
| Construction and Farm<br>land:               |           |                   |                    |             |            |               |           |
| Residential                                  | 5,112     | 89                | —                  | —           | —          | —             | 5,201     |
| Commercial                                   | 23,192    | 5,184             | 2,083              | 750         | 79         | —             | 31,288    |
| Residential:                                 |           |                   |                    |             |            |               |           |
| Equity Lines                                 | 29,440    | 1,429             | —                  | 185         | 67         | —             | 31,121    |
| Single family                                | 165,932   | 21,011            | —                  | 6,062       | 568        | —             | 193,573   |
| Multifamily                                  | 2,144     | 872               | —                  | —           | —          | —             | 3,016     |
| All other loans                              | 2,316     | —                 | —                  | —           | —          | —             | 2,316     |
| Total  | \$373,324 | \$62,540          | \$3,506            | \$13,620    | \$2,956    | \$—           | \$455,946 |
| Consumer Credit Exposure by Payment Activity |           |                   |                    |             | Performing | Nonperforming |           |
|  |           |                   |                    |             | \$13,803   | \$71          |           |

## NOTE 6. Troubled Debt Restructurings

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

- The borrower receives a reduction of the stated interest rate to a rate less than the institution is willing to accept at the time of the restructure for a new loan with comparable risk.
- The borrower receives an extension of the maturity date or dates at a stated interest rate lower than the current market interest rate for new debt with similar risk characteristics.
- The borrower receives a reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
- The borrower receives a deferral of required payments (principal and/or interest).
- The borrower receives a reduction of the accrued interest.

There were twenty-three (23) troubled debt restructured loans totaling \$7.8 million at September 30, 2015. At December 31, 2014, there were twenty-five (25) troubled debt restructured loans totaling \$7.8 million. Two loans, totaling \$340 thousand, were in nonaccrual status at September 30, 2015. Eight loans, totaling \$1.4 million, were in nonaccrual status at December 31, 2014. There were no outstanding commitments to lend additional amounts to troubled debt restructured borrowers at September 30, 2015 or December 31, 2014.





The following tables and narrative set forth information on the Company's troubled debt restructurings by class of financing receivable occurring during the three and nine months ended September 30, 2015 and September 30, 2014:

|                               |  | Three Months Ended<br>September 30, 2015<br>(in thousands) |  |   |
|-------------------------------|--|--|--|---|
|                               |  | Number of<br>Contracts                                     | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
| Residential:                  |  |  |  |   |
| Single family                 |  | 1  | \$ 169   | \$ 169  |
|                               |  | 1  | \$ 169   | \$ 169  |
|                               |  | Three Months Ended<br>September 30, 2014<br>(in thousands) |  |   |
|                               |  | Number of<br>Contracts                                     | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
| Commercial - Non Real Estate: |  |  |  |   |
| Commercial & Industrial       |  | 1  | \$ 289   | \$ 289  |
| Residential:                  |  |  |  |   |
| Equity                        |  | 1  | 69   | 69  |
| Single family                 |  | 1  | 652  | 350   |
|                               |  | 3  | \$ 1,010   | \$ 708  |
|                               |  | Nine Months Ended<br>September 30, 2015<br>(in thousands)  |  |   |
|                               |  | Number of<br>Contracts                                     | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
| Residential:                  |  |  |  |   |
| Single family                 |  | 2  | \$ 688   | \$ 688  |
| Total                         |  | 2  | \$ 688   | \$ 688  |
|                               |  | Nine Months Ended<br>September 30, 2014<br>(in thousands)  |  |   |
|                               |  | Number of<br>Contracts                                     | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
| Commercial - Non Real Estate: |  |  |  |   |
| Commercial & Industrial       |  | 1  | \$ 289   | \$ 289  |
| Residential:                  |  |  |  |   |
| Equity Lines                  |  | 1  | 69   | 69  |
| Single family                 |  | 1  | 652  | 350   |
| Total                         |  | 3  | \$ 1,010   | \$ 708  |



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

During the nine months ended September 30, 2015, the Company restructured one additional loan by granting concessions to borrowers experiencing financial difficulties. One residential loan was modified by changing the amortization period and interest rate in order to reduce the monthly payments.

During the three and nine months ended September 30, 2014, the Company restructured three loans by granting concessions to borrowers experiencing financial difficulties. One commercial and industrial loan and one residential single family loan was modified by reducing the monthly payments. One residential equity loan was modified by changing payments to interest only for a period of time.

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

|                            | Three Months Ended<br>September 30, 2014<br>(in thousands) |                        |
|----------------------------|--|------------------------|
|                            | Number of<br>Contracts                                     | Recorded<br>Investment |
| Construction and Farmland: |  |                        |
| Commercial                 | 2  | \$ 1,608               |
| Total                      | 2  | \$ 1,608               |

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

|                            | Nine Months Ended<br>September 30, 2014<br>(in thousands) |                        |
|----------------------------|---|------------------------|
|                            | Number of<br>Contracts                                    | Recorded<br>Investment |
| Construction and Farmland: |   |                        |
| Commercial                 | 2   | \$ 1,608               |
| Total                      | 2   | \$ 1,608               |

There were no payment defaults during the three months ended September 30, 2015. A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

## NOTE 7. Deposits

The composition of deposits at September 30, 2015 and December 31, 2014 was as follows:

|   | September 30,<br>2015 | December 31,<br>2014 |
|---|-----------------------|----------------------|
|   | (in thousands)        |                      |
| Noninterest bearing demand deposits           | \$ 177,005            | \$ 159,352           |
| Savings and interest bearing demand deposits: |                       |                      |
| NOW accounts                                  | \$ 77,494             | \$ 81,441            |
| Money market accounts                         | 100,090               | 98,314               |
| Regular savings accounts                      | 77,551                | 69,550               |
|   | \$ 255,135            | \$ 249,305           |
| Time deposits:                                |                       |                      |
| Balances of less than \$250,000               | \$ 82,382             | \$ 85,899            |
| Balances of \$250,000 and more                | 13,349                | 9,260                |
|   | \$ 95,731             | \$ 95,159            |
|   | \$ 527,871            | \$ 503,816           |

## NOTE 8. Postretirement Benefit Plans

The Company provides certain health care and life insurance benefits for nine retired employees who have met certain eligibility requirements. All other employees retiring after reaching age 65 and having at least 15 years of service with the Company will be allowed to stay on the Company's group life and health insurance policies, but will be required to pay premiums. The Company's share of the estimated costs that will be paid after retirement is generally being accrued by charges to expense over the employees' active service periods to the dates they are fully eligible for benefits.

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

Net periodic benefit costs of the postretirement benefit plan for the three months ended September 30, 2015 and 2014 were zero and \$(1) thousand, respectively. Net periodic benefit costs of the postretirement benefit plan for the nine months ended September 30, 2015 and 2014 were \$(1) thousand and \$(3) thousand, respectively.

## NOTE 9. Trust Preferred Capital Notes

In September 2007, Eagle Financial Statutory Trust II (the "Trust II"), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On September 20, 2007, Trust II issued \$7.0 million of trust preferred securities and \$217 thousand in common equity. At December 31, 2014, the principal asset of Trust II was \$7.2 million of the Company's junior subordinated debt securities with the same maturity and interest rate structures as the capital securities. On July 29, 2015, the pool to which the Company's \$7.0 million in outstanding trust preferred capital notes belonged was liquidated by means of auction. The Company was successful in purchasing the outstanding notes at a price of 65.375% of par or \$4.6 million in cash, resulting in a gain on the redemption of \$2.4 million. On August 7, 2015, the Trust II was dissolved.

Outstanding trust preferred securities are included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At December 31, 2014, the total amount (\$7.0 million) of trust preferred securities issued by Trust II was included in the Company's Tier 1 capital.

NOTE 10. Fair Value Measurements

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

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

- Level 1 Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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

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

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

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The following table presents balances of financial assets and liabilities measured at fair value on a recurring basis at September 30, 2015 and December 31, 2014:

|  | Balance as of                           | Fair Value Measurements at                                       |  |                                       |
|--|---|--|--|---------------------------------------|
|  |   | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
|  | September 30,<br>2015<br>(in thousands) | (Level 1)  | (Level 2)                                    | (Level 3)                             |
| Assets:  |   |  |  |                                       |
| Securities available for sale                            |   |  |  |                                       |
| Obligations of U.S. government corporations and agencies | \$39,385                                | \$—  | \$39,385                                     | \$—                                   |
| Mortgage-backed securities                               | 21,412                                  | —  | 21,412                                       | —                                     |
| Obligations of states and political subdivisions         | 40,385                                  | —  | 40,385                                       | —                                     |
| Total assets at fair value                               | \$101,182                               | \$—  | \$101,182                                    | \$—                                   |
| Liabilities:   |   |  |  |                                       |
| Interest rate swap                                       | \$207                                   | —  | \$207  | —                                     |
| Total liabilities at fair value                          | \$207                                   | \$—  | \$207  | \$—                                   |
|  |   |  |  |                                       |
|  |   | Fair Value Measurements at                                       |  |                                       |
|  |   | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
|  | December 31,<br>2014<br>(in thousands)  | (Level 1)  | (Level 2)                                    | (Level 3)                             |
| Assets:  |   |  |  |                                       |
| Securities available for sale                            |   |  |  |                                       |
| Obligations of U.S. government corporations and agencies | \$37,211                                | \$—  | \$37,211                                     | \$—                                   |
| Mortgage-backed securities                               | 15,779                                  | —  | 15,779                                       | —                                     |
| Obligations of states and political subdivisions         | 40,410                                  | —  | 40,410                                       | —                                     |
| Corporate securities                                     | 765                                     | —  | 765  | —                                     |
| Total assets at fair value                               | \$94,165                                | \$—  | \$94,165                                     | \$—                                   |
| Liabilities:   |   |  |  |                                       |
| Interest rate swap                                       | \$289                                   | —  | \$289  | —                                     |
| Total liabilities at fair value                          | \$289                                   | \$—  | \$289  | \$—                                   |



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

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

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

Other Real Estate Owned: Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the fair value of the property, less estimated selling costs, establishing a new costs basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. Valuations are periodically obtained by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. The fair value measurement of real estate held in other real estate owned is assessed in the same manner as impaired loans described above. We believe that the fair value component in its valuation follows the provisions of GAAP.

The following table displays quantitative information about Level 3 Fair Value Measurements for certain financial assets measured at fair value on a nonrecurring basis at September 30, 2015 (dollars in thousands):

| Quantitative information about Level 3 Fair Value Measurements for September 30, 2015 |                            |                    |          |                  |
|---|----------------------------|--------------------|----------|------------------|
|   | Valuation Technique(s)     | Unobservable Input | Range    | Weighted Average |
| Assets:   |                            |                    |          |                  |
| Impaired loans  | Discounted appraised value | Selling cost       | 6% - 20% | 14%              |
| Other real estate owned   | Discounted appraised value | Selling cost       | 6% - 13% | 9%               |

The following table summarizes the Company's financial and nonfinancial assets that were measured at fair value on a nonrecurring basis at September 30, 2015 and December 31, 2014:

|                         | Balance as of<br>September 30,<br>2015<br>(in thousands) | Fair Value at<br>September 30, 2015   |   |  |
|-------------------------|--|---|---|--|
|                         |  | Identical<br>Assets<br>(Level 1)  | Observable<br>Inputs<br>(Level 2)                         | Unobservable<br>Inputs<br>(Level 3)                |
| Financial Assets:       |  |   |   |  |
| Impaired loans          | \$3,853  | \$—   | \$—   | \$3,853  |
| Nonfinancial Assets:    |  |   |   |  |
| Other real estate owned | 1,848  | —   | —   | 1,848  |
|                         | Balance as of<br>December 31,<br>2014<br>(in thousands)  | Fair Value at<br>December 31, 2014  |   |  |
|                         |  | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial Assets:       |  |   |   |  |
| Impaired loans          | \$1,751  | \$—   | \$—   | \$1,751  |
| Nonfinancial Assets:    |  |   |   |  |
| Other real estate owned | 2,102  | —   | —   | 2,102  |

GAAP defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than through a forced or liquidation sale for purposes of this disclosure. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The following methods and assumptions were used to estimate the fair value of the Company's financial instruments:

Cash and due from banks and interest-bearing deposits/accrued interest: The fair value was equal to the carrying amount.

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

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

Deposits and borrowings: The fair value of demand deposits, savings accounts, and certain money market deposits was equal to the carrying amount. The fair value of all other deposits and borrowings was determined using

discounted cash flow analysis. The discount rate was equal to the current interest rate on similar products.

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

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The carrying value and fair value of the Company's financial instruments at September 30, 2015 and December 31, 2014 were as follows:

|   | Fair Value Measurements at<br>September 30, 2015<br>Using |  |  |                                       |                       |
|---|---|--|--|---------------------------------------|-----------------------|
|   | Carrying Value<br>as of                                   | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs | Fair Value as<br>of   |
|   | September 30,<br>2015<br>(in thousands)                   | (Level 1)  | (Level 2)                                    | (Level 3)                             | September 30,<br>2015 |
| <b>Financial Assets:</b>                              |   |  |  |                                       |                       |
| Cash and due from banks and interest-bearing deposits | \$16,941  | \$16,941   | \$—  | \$—                                   | \$16,941              |
| Securities available for sale                         | 101,182   | —  | 101,182                                      | —                                     | 101,182               |
| Restricted Investments                                | 2,321   | —  | 2,321  | —                                     | 2,321                 |
| Loans, net  | 486,052   | —  | —  | 490,524                               | 490,524               |
| Accrued interest receivable                           | 1,723   | —  | 1,723  | —                                     | 1,723                 |
| <b>Financial Liabilities:</b>                         |   |  |  |                                       |                       |
| Deposits  | \$527,871   | \$—  | \$527,765                                    | \$—                                   | \$527,765             |
| Federal Home Loan Bank advances                       | 30,000  | —  | 30,042                                       | —                                     | 30,042                |
| Accrued interest payable                              | 64  | —  | 64   | —                                     | 64                    |
| Interest rate swap contract                           | 207   | —  | 207  | —                                     | 207                   |

|   | Fair Value Measurements at<br>December 31, 2014<br>Using |  |  |                                       |                      |
|---|--|--|--|---------------------------------------|----------------------|
|   | Carrying Value<br>as of                                  | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs | Fair Value as<br>of  |
|   | December 31,<br>2014<br>(in thousands)                   | (Level 1)  | (Level 2)                                    | (Level 3)                             | December 31,<br>2014 |
| <b>Financial assets:</b>                              |  |  |  |                                       |                      |
| Cash and due from banks and interest-bearing deposits | \$34,564   | \$34,564   | \$—  | \$—                                   | \$34,564             |
| Securities available for sale                         | 94,165   | —  | 94,165                                       | —                                     | 94,165               |
| Restricted Investments                                | 2,808  | —  | 2,808  | —                                     | 2,808                |
| Loans, net  | 464,740  | —  | —  | 470,781                               | 470,781              |
| Accrued interest receivable                           | 1,703  | —  | 1,703  | —                                     | 1,703                |
| <b>Financial liabilities:</b>                         |  |  |  |                                       |                      |

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|                                 |           |     |           |     |           |
|---------------------------------|-----------|-----|-----------|-----|-----------|
| Deposits                        | \$503,816 | \$— | \$503,917 | \$— | \$503,917 |
| Federal Home Loan Bank advances | 40,000    | —   | 40,152    | —   | 40,152    |
| Trust preferred capital notes   | 7,217     | —   | 7,217     | —   | 7,217     |
| Accrued interest payable        | 160       | —   | 160       | —   | 160       |
| Interest rate swap contract     | 289       | —   | 289       | —   | 289       |

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

#### NOTE 11. Derivative Instruments and Hedging Activities

##### Interest Rate Swaps

The Company uses interest rate swaps to reduce interest rate risk and to manage interest expense. By entering into these agreements, the Company converts floating rate debt into fixed rate debt, or alternatively, converts fixed rate debt into floating rate debt. Interest differentials paid or received under the swap agreements are reflected as adjustments to interest expense. These interest rate swap agreements are derivative instruments that qualify for hedge accounting as discussed below. The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counterparty, the risk in these transactions is the cost of replacing the agreements at current market rates.

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

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

On December 4, 2008, the Company entered into an interest rate swap agreement related to the outstanding trust preferred capital notes. The swap agreement became effective on December 1, 2008. The notional amount of the interest rate swap was \$7.0 million and has an expiration date of December 1, 2016. Under the terms of the agreement, the Company pays interest quarterly at a fixed rate of 2.85% and receives interest quarterly at a variable rate of three month LIBOR. The variable rate resets on each interest payment date. This agreement was designated as a cash-flow hedge at inception of the contract until the redemption of the trust preferred capital notes on July 29, 2015. As a result

of the redemption, the derivative contract is no longer classified as a cash flow hedge and is currently recorded in the balance sheet at its fair value with changes in fair value recorded in Other operating (loss) income in the Consolidated Statements of Income.



The following table summarizes the fair value of derivative instruments at September 30, 2015 and December 31, 2014:

|  | September 30, 2015     |            | December 31, 2014      |            |
|--|------------------------|------------|------------------------|------------|
|  | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| (dollars in thousands)                                       |                        |            |                        |            |
| Derivatives designated as hedging instruments under GAAP     |                        |            |                        |            |
| Interest rate swap contracts                                 | Other Liabilities      | \$—        | Other Liabilities      | \$289      |
| Derivatives not designated as hedging instruments under GAAP |                        |            |                        |            |
| Interest rate swap contracts                                 | Other Liabilities      | 207        | Other Liabilities      | —          |

The following tables present the effect of the derivative instrument on the Consolidated Balance Sheets at September 30, 2015 and 2014 and the Consolidated Statements of Income for the three and nine months ended September 30, 2015 and 2014:

|  | Three Months Ended     |                       |                       | Amount of Gain         |                        |
|--|------------------------|-----------------------|-----------------------|------------------------|------------------------|
|  | September 30,          |                       |                       | Amount of Gain         |                        |
|  | Amount of Gain         |                       |                       | (Loss)                 |                        |
|  | (Loss)                 | Location of Gain      |                       | Recognized in Income   |                        |
| Derivatives in GAAP                      | Recognized in OCI      | (Loss)                | Recognized in Income  | (Ineffective Portion)  |                        |
| Cash Flow Hedging Relationships          | on Derivative          | Recognized in Income  | Recognized in Income  | (Ineffective Portion)  |                        |
|  | (Effective Portion)    | (Ineffective Portion) | (Ineffective Portion) | 2015                   | 2014                   |
|  | 2015                   | 2014                  |                       | (dollars in thousands) | (dollars in thousands) |
|  | (dollars in thousands) |                       |                       |                        |                        |
| Interest rate swap contracts, net of tax | \$—                    | \$41                  | n/a                   | \$—                    | \$—                    |
|  |                        |                       |                       |                        |                        |
|  | Nine Months Ended      |                       |                       | Amount of Gain         |                        |
|  | September 30,          |                       |                       | Amount of Gain         |                        |
|  | Amount of Gain         |                       |                       | (Loss)                 |                        |
| Derivatives in GAAP                      | Recognized in OCI      | (Loss)                | Location of Gain      | Recognized in Income   |                        |
| Cash Flow Hedging Relationships          | on Derivative          | Recognized in Income  | Recognized in Income  | (Ineffective Portion)  |                        |
|  | (Effective Portion)    | (Ineffective Portion) | (Ineffective Portion) | 2015                   | 2014                   |
|  | 2015                   | 2014                  |                       | (dollars in thousands) | (dollars in thousands) |
|  | (dollars in thousands) |                       |                       |                        |                        |
| Interest rate swap contracts, net of tax | \$—                    | \$79                  | n/a                   | \$—                    | \$—                    |

The balance of the interest rate swap liability was \$237 thousand at the time of the redemption of the Company's trust preferred debt on July 29, 2015. The total amount recorded in accumulated other comprehensive income at that date was reclassified to earnings due to the derecognition of the cash flow hedge. Subsequent to the redemption of the debt and reclassification, the interest rate swap derivative was adjusted to its fair value resulting in a \$30 thousand gain recorded in other operating (loss) income for the three and nine months ended September 30, 2015.

NOTE 12. Change in Accumulated Other Comprehensive Income

Accumulated other comprehensive income includes unrealized gains and losses on available for sale securities, change in fair value of interest rate swaps and changes in benefit obligations and plan assets for the post retirement benefit plan. Changes to accumulated other comprehensive income are presented net of tax effect as a component of equity. Reclassifications out of accumulated other comprehensive income are recorded in the Consolidated Statements of Income either as a gain or loss.

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Changes to accumulated other comprehensive income by components are shown in the following tables for the periods indicated:

|  | Three Months Ended<br>September 30,<br>2015                                 |   |  |         | 2014  |   |   |         |
|--|---|---|--|---------|---|---|---|---------|
|  | Unrealized<br>Gains and<br>Losses on<br>Available<br>for Sale<br>Securities | Change in<br>Fair Value<br>of Interest<br>Rate Swap | Change in<br>Benefit<br>Obligations<br>and Plan<br>Assets for<br>the Post<br>Retirement<br>Benefit<br>Plan | Total   | Unrealized<br>Gains and<br>Losses on<br>Available<br>for Sale<br>Securities | Change in<br>Fair Value<br>of Interest<br>Rate Swap | Change in<br>Benefit<br>Obligations<br>and Plan<br>Assets for<br>the Post<br>Retirement<br>Benefit Plan | Total   |
|  | (dollars in thousands)  |   |  |         |   |   |   |         |
| July 1   | \$851   | \$(156)   | )\$39  | \$734   | \$1,766   | \$(248)   | )\$44   | \$1,562 |
| Other<br>comprehensive<br>income before<br>reclassifications           | 782   | —   | —  | 782     | (28)  | )63   | —   | 35      |
| Reclassifications<br>adjustments                                       | (20)  | )237  | —  | 217     | (87)  | )—  | —   | (87)    |
| Tax effect of<br>current period<br>changes                             | (259)   | )81   | )—   | (340)   | )39   | (22)  | )—  | 17      |
| Current period<br>changes net of<br>taxes                              | 503   | 156   | —  | 659     | (76)  | )41   | —   | (35)    |
| September 30   | \$1,354   | \$—   | \$39   | \$1,393 | \$1,690   | \$(207)   | )\$44   | \$1,527 |
|  | Nine Months Ended<br>September 30,<br>2015                                  |   |  |         | 2014  |   |   |         |
|  | Unrealized<br>Gains and<br>Losses on<br>Available<br>for Sale<br>Securities | Change in<br>Fair Value<br>of Interest<br>Rate Swap | Change in<br>Benefit<br>Obligations<br>and Plan<br>Assets for<br>the Post<br>Retirement<br>Benefit<br>Plan | Total   | Unrealized<br>Gains and<br>Losses on<br>Available<br>for Sale<br>Securities | Change in<br>Fair Value<br>of Interest<br>Rate Swap | Change in<br>Benefit<br>Obligations<br>and Plan<br>Assets for<br>the Post<br>Retirement<br>Benefit Plan | Total   |
|  | (dollars in thousands)  |   |  |         |   |   |   |         |
| January 1  | \$1,466   | \$(190)   | )\$39  | \$1,315 | \$547   | \$(286)   | )\$44   | \$305   |
| Other<br>comprehensive<br>(loss) income<br>before<br>reclassifications | (54)  | )52   | —  | (2)     | )1,824  | 120   | —   | 1,944   |
|  | (116)   | )237  | —  | 121     | (93)  | )—  | —   | (93)    |

|  |         |      |      |         |         |        |       |         |
|--|---------|------|------|---------|---------|--------|-------|---------|
| Reclassifications<br>adjustments           |         |      |      |         |         |        |       |         |
| Tax effect of<br>current period<br>changes | 58      | (99  | )—   | (41     | )(588   | )(41   | )—    | (629    |
| Current period<br>changes net of<br>taxes  | (112    | )190 | —    | 78      | 1,143   | 79     | —     | 1,222   |
| September 30                               | \$1,354 | \$—  | \$39 | \$1,393 | \$1,690 | \$(207 | )\$44 | \$1,527 |

For the three and nine months ended September 30, 2015, \$20 thousand and \$116 thousand, respectively, was reclassified out of accumulated other comprehensive income and appeared as Gain on sale of securities in the Consolidated Statements of Income. The tax related to these reclassifications was \$7 thousand and \$39 thousand for the three and nine months ended September 30, 2015, respectively. For the three and nine months ended September 30, 2014, \$87 thousand and \$93 thousand, respectively, was reclassified out of comprehensive income and appeared as Gain on sale of securities in the Consolidated Statements of Income. The tax related to these reclassifications was \$30 thousand and \$32 thousand, respectively, for the three and nine months ended September 30, 2014. The tax is included in Income Tax Expense in the Consolidated Statements of Income.

For the three and nine months ended September 30, 2015, \$237 thousand was reclassified out of accumulated other comprehensive income related to the Company's derecognition of its cash flow hedge. This loss was recorded in Other operating (loss) income in the Consolidated Statements of Income. Tax related to this reclassification was \$81 thousand and was included in Income Tax Expense in the Consolidated Statements of Income. There were no reclassifications related to cash flow hedges during the three and nine months ended September 30, 2014.

#### NOTE 13. Recent Accounting Pronouncements

In June 2014, the FASB issued ASU No. 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures". This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on our consolidated financial statements.

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 adoption of the new guidance did not have a material impact on our 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 April 2015, the FASB issued ASU No. 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement." The amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments do not change the accounting for a customer's accounting for service contracts. As a result of the amendments, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets. The amendments in this ASU are effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. An entity can elect to adopt the amendments either: (1) prospectively to all arrangements entered into or materially modified after the effective date; or (2) retrospectively. The Company is currently assessing the impact that ASU 2015-05 will have on its consolidated financial statements.

In May 2015, the FASB issued ASU No. 2015-08, "Business Combinations (Topic 805): Pushdown Accounting - Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115." The amendments in ASU 2015-08 amend various SEC paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 115, Topic 5: Miscellaneous Accounting, regarding various pushdown accounting issues, and did not have a material impact on our 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 Company does not expect the adoption of ASU 2015-15 to have a material impact on its 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.

## NOTE 14. Other Real Estate Owned

The following table is a summary of other real estate owned (OREO) activity for the nine months ended September 30, 2015 and 2014 and the year ended December 31, 2014:

|                               | Nine Months Ended<br>September 30,<br>2015<br>(in thousands) | Year Ended<br>December 31,<br>2014 | Nine Months Ended<br>September 30,<br>2014 |
|-------------------------------|--|------------------------------------|--|
| Balance, beginning            | \$2,102  | \$1,646                            | \$1,646                                    |
| Net loans transferred to OREO | 736  | 1,248                              | 680  |
| Sales                         | (937   | ) (792                             | ) (682                                     |
| Valuation adjustments         | (53  | ) —                                | —  |
| Balance, ending               | \$1,848  | \$2,102                            | \$1,644                                    |

The major classifications of other real estate owned in the consolidated balance sheets at September 30, 2015 and December 31, 2014 were as follows:

|                           | As of<br>September 30, 2015<br>(in thousands) | December 31, 2014 |
|---------------------------|---|-------------------|
| Construction and Farmland | \$1,271                                       | \$1,531           |
| Residential Real Estate   | 630   | 166               |
| Commercial Real Estate    | —   | 405               |
| Subtotal                  | \$1,901                                       | \$2,102           |
| Less valuation allowance  | 53  | —                 |
| Total                     | \$1,848                                       | \$2,102           |

There were no consumer mortgage loans collateralized by residential real estate in the process of foreclosure at September 30, 2015 and December 31, 2014.

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

The purpose of this discussion is to focus on the important factors affecting the Company's financial condition, results of operations, liquidity and capital resources. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and the Notes to the Consolidated Financial Statements presented in Part I, Item 1, Financial Statements, of this Form 10-Q and Item 8, Financial Statements and Supplementary Data, of the 2014 Form 10-K.

GENERAL

Eagle Financial Services, Inc. is a bank holding company which owns 100% of the stock of Bank of Clarke County (the "Bank" and collectively with Eagle Financial Services, Inc., the "Company"). Accordingly, the results of operations for the Company are dependent upon the operations of the Bank. The Bank conducts commercial banking business which consists of attracting deposits from the general public and investing those funds in commercial, consumer and real estate loans and 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 September 30, 2015, the Company had total assets of \$638.1 million, net loans of \$486.1 million, total deposits of \$527.9 million, and shareholders' equity of \$77.6 million. The Company's net income was \$5.5 million for the nine months ended September 30, 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 its local, independent status.

OPERATING STRATEGY

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

As interest rates change, the Bank attempts to maintain its net interest margin. This is accomplished by changing the price, terms, and mix of its financial assets and liabilities. The Bank also earns fees on services provided through its trust department, sales of investments through Eagle Investment Services, mortgage originations and deposit operations. The Bank also incurs noninterest expenses such as compensating employees, maintaining and acquiring fixed assets, and purchasing goods and services necessary to support its daily operations.

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

## LENDING POLICIES

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

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

The Bank uses a tiered approach to approve credit requests consisting of individual lending authorities, a senior management loan committee, and a director loan committee. Lending limits for individuals and the Senior Loan Committee are set by the Board of Directors and are determined by loan purpose, collateral type, and internal risk rating of the borrower. The highest individual authority (Category I) is assigned to the Bank's President / Chief Executive Officer, Senior Loan Officer and Senior Credit Officer (approval authority only). Two officers in Category I may combine their authority to approve loan requests to borrowers with credit exposure up to \$1.0 million on a secured basis and \$500 thousand unsecured. Officers in Category II, III, IV, V, VI and VII have lesser authorities and with approval of a Category I officer may extend loans to borrowers with exposure of \$500 thousand on a secured basis and \$250 thousand unsecured. Loan exposures up to \$1.0 million may be approved with the concurrence of two, Category I officers. Loans to borrowers with total credit exposures between \$1.0 million and \$3.0 million are approved by the Senior Loan Committee consisting of the President, Chief Operating Officer, Senior Loan Officer, Senior Credit Officer, and Chief Financial Officer. Approval of the Senior Loan Committee is required prior to being referred to the Director Loan Committee for approval. Loans exceeding \$3 million and up to the Bank's legal lending limit can be approved by the Director Loan Committee consisting of four directors (three directors constituting a quorum). The Director's Loan Committee also reviews and approves changes to the Bank's Loan Policy as presented by management.

The following sections discuss the major loan categories within the total loan portfolio:

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

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

#### Commercial Real Estate Lending

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



### Construction and Land Development Lending

The Bank makes local construction loans, primarily residential, and land acquisition and development loans. The construction loans are secured by residential houses under construction and the underlying land for which the loan was obtained. The average life of most construction loans is less than one year and the Bank offers both fixed and variable rate interest structures. The interest rate structure offered to customers depends on the total amount of these loans outstanding and the impact of the interest rate structure on the Bank's overall interest rate risk. There are two characteristics of construction lending which impact its overall risk as compared to residential mortgage lending. First, there is more concentration risk due to the extension of a large loan balance through several lines of credit to a single developer or contractor. Second, there is more collateral risk due to the fact that loan funds are provided to the borrower based upon the estimated value of the collateral after completion. This could cause an inaccurate estimate of the amount needed to complete construction or an excessive loan-to-value ratio. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of the estimated appraised value of the finished construction project. The Bank also obtains a first lien on the property as security for its construction loans and typically requires personal guarantees from the borrower's principal owners. Finally, the Bank performs inspections of the construction projects to ensure that the percentage of construction completed correlates with the amount of draws on the construction line of credit.

### Commercial and Industrial Lending

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

### Consumer Lending

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

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



applicant is the primary consideration, the underwriting process also includes an analysis of the value of the security in relation to the proposed loan amount.

#### CRITICAL ACCOUNTING POLICIES

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

The allowance for loan losses is an estimate of probable losses inherent in the Company's loan portfolio. As required by GAAP, the allowance for loan losses is accrued when their occurrence is probable and they can be estimated, including impairment losses based on the differences between the loan balance and the value of its collateral, the present value of future cash flows, or the price established in the secondary market. The Company's allowance for loan losses has three basic components: the general allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when actual events occur. The general allowance uses historical experience and other qualitative factors to estimate future losses and, as a result, the estimated amount of losses can differ significantly from the actual amount of losses which would be incurred in the future. However, the potential for significant differences is mitigated by continuously updating the loss history of the Company. The specific allowance is based upon the evaluation of specific loans on which a loss may be realized. Factors such as past due history, ability to pay, and collateral value are used to identify those loans on which a loss may be realized. Each of these loans is then evaluated to determine how much loss is estimated to be realized on its disposition. The sum of the estimated losses on the individual loans becomes the Company's specific allowance. This process is inherently subjective and actual losses may be greater than or less than the estimated specific allowance. The unallocated allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating general and specific losses in the portfolio. As specific loans are identified or losses are experienced on these loans, they will be reflected within the general or specific allowances. Note 1 to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Data, of the 2014 Form 10-K, provides additional information related to the allowance for loan losses.

#### FORWARD LOOKING STATEMENTS

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

- the ability to successfully manage growth or implement growth strategies if the Bank is unable to identify attractive markets, locations or opportunities to expand in the future;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- the successful management of interest rate risk;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- changes in general economic and business conditions in the market area;
- reliance on the management team, including the ability to attract and retain key personnel;
- changes in interest rates and interest rate policies;
- maintaining capital levels adequate to support growth;
- maintaining cost controls and asset qualities as new branches are opened or acquired;
- demand, development and acceptance of new products and services;
- problems with technology utilized by the Bank;
- changing trends in customer profiles and behavior;
- changes in banking and other laws and regulations; and
- other factors described in Item 1A., "Risk Factors," in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

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



## RESULTS OF OPERATIONS

### Net Income

Net income for the nine months ended September 30, 2015 was \$5.5 million, an increase of \$836 thousand or 17.76% as compared to net income for the nine months ended September 30, 2014 of \$4.7 million. Basic and diluted earnings per share were \$1.59 and \$1.37 for the nine months ended September 30, 2015 and 2014, respectively. Net income during the third quarter of 2015 was \$3.3 million, an increase of \$1.9 million or 137.47% as compared to net income during the third quarter of 2014 of \$1.4 million. Earnings per share, basic and diluted were \$0.94 and \$0.40 for the third quarter of 2015 and 2014, respectively.

Return on average assets (ROA) measures how efficiently the Company uses its assets to produce net income. Some issues reflected within this efficiency include the Company's asset mix, funding sources, pricing, fee generation, and cost control. The ROA of the Company, on an annualized basis, for the nine months ended September 30, 2015 and 2014 was 1.19% and 1.06%, respectively.

Return on average equity (ROE) measures the utilization of shareholders' equity in generating net income. This measurement is affected by the same factors as ROA with consideration to how much of the Company's assets are funded by shareholders. The ROE of the Company, on an annualized basis, for the nine months ended September 30, 2015 and 2014 was 9.95% and 9.12%, respectively.

### Net Interest Income

Net interest income is our primary source of revenue, representing the difference between interest and fees earned on interest-earning assets and the interest paid on deposits and other interest-bearing liabilities. The level of net interest income is impacted primarily by variations in the volume and mix of these assets and liabilities, as well as changes in interest rates. Net interest income was \$17.3 million for the nine months ended September 30, 2015 and 2014. Net interest income was \$5.9 million and \$5.8 million for the three months ended September 30, 2015 and 2014, respectively, which represents an increase of \$171 thousand or 2.96%. Average interest earning assets increased \$29.7 million from the three months ended September 30, 2014 to the three months ended September 30, 2015 while the average yield decreased 22 basis points over that same period.

Total interest income was \$18.3 million and \$18.8 million for the nine months ended September 30, 2015 and 2014, respectively, which represents a decrease of \$475 thousand or 2.53%. Total interest income was \$6.3 million for the three months ended September 30, 2015 and 2014. Total interest expense was \$1.0 million and \$1.5 million for the nine months ended September 30, 2015 and 2014, respectively, which represents a decrease of \$418 thousand or 28.57%. Total interest expense was \$321 thousand and \$480 thousand for the three months ended September 30, 2015 and 2014, respectively, which represents a decrease of \$159 thousand or 33.13%. The decrease in interest expense during both periods is attributable to decreases in outstanding FHLB advances year over year coupled with higher rate advances being replaced with lower rate advances. In addition, there have been shifts in the deposit mix from higher interest time deposit accounts to lower interest or noninterest bearing deposit accounts. Average interest bearing liabilities increased \$5.8 million for the three months ended September 30, 2015 as compared to the three months ended September 30, 2014 while the rate on interest bearing liabilities decreased 17 basis points over the same period.

The net interest margin was 4.09% and 4.26% for the nine months ended September 30, 2015 and 2014, respectively. The net interest margin was 4.07% and 4.18% for the three months ended September 30, 2015 and 2014, respectively. 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 and 2014. The following table reconciles tax-equivalent net interest income, which is not a measurement under accounting principles generally accepted in the United States of America (GAAP), to net interest income.

Net interest income and net interest margin may experience some 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.

|   | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|---------|------------------------------------|----------|
|   | 2015                                | 2014    | 2015                               | 2014     |
|   | (in thousands)                      |         | (in thousands)                     |          |
| GAAP Financial Measurements:                                    |                                     |         |                                    |          |
| Interest Income - Loans   | \$5,540                             | \$5,397 | \$16,278                           | \$16,317 |
| Interest Income - Securities and Other Interest-Earnings Assets | 725                                 | 856     | 2,046                              | 2,482    |
| Interest Expense - Deposits                                     | 185                                 | 241     | 551                                | 730      |
| Interest Expense - Other Borrowings                             | 136                                 | 239     | 494                                | 733      |
| Total Net Interest Income                                       | \$5,944                             | \$5,773 | \$17,279                           | \$17,336 |
| Non-GAAP Financial Measurements:                                |                                     |         |                                    |          |
| Add: Tax Benefit on Tax-Exempt Interest Income - Loans          | \$29                                | \$32    | \$90                               | \$74     |
| Add: Tax Benefit on Tax-Exempt Interest Income - Securities     | 126                                 | 139     | 378                                | 430      |
| Total Tax Benefit on Tax-Exempt Interest Income                 | \$155                               | \$171   | \$468                              | \$504    |
| Tax-Equivalent Net Interest Income                              | \$6,099                             | \$5,944 | \$17,747                           | \$17,840 |

The tax-equivalent yield on earning assets decreased 28 basis points from 4.61% for the nine months ended September 30, 2014 to 4.33% for the same period in 2015. During that same time, the tax-equivalent yield on securities decreased 47 basis points from 3.74% to 3.27%. The tax equivalent yield on loans decreased 17 basis points from 4.78% for the nine months ended September 30, 2014 to 4.61% for the same time period in 2015. The average rate on interest bearing liabilities decreased 15 basis points from 0.52% for the nine months ended September 30, 2014 to 0.37% for the same time period in 2015. The average rate on interest bearing deposits decreased 8 basis points from 0.29% to 0.21% during that same time. The Company's management of interest rates on deposits contributed to the decrease in costs. In general, deposit pricing is done in response to monetary policy actions and yield curve changes. Also, local competition for funds affects the cost of time deposits, which are primarily comprised of certificates of deposit. The Company prefers to rely more heavily on non-maturity deposits, which include NOW accounts, money market accounts, and savings accounts. 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 utilizes overnight borrowings in the form of federal funds purchased. The average rate on these borrowings decreased from 1.07% to 0.87% for the nine months ended September 30, 2014 and 2015, respectively. The Company also borrows from the FHLB in the form of short and long term advances. The average rate on FHLB advances decreased 89 basis points from 2.30% to 1.41% for the nine months ended September 30, 2014 and 2015. As advances mature and the funding need arises, higher rate FHLB borrowings have been replaced by lower rate FHLB borrowings due to the current interest rate environment. There were no significant changes in asset mix during the nine months ended September 30, 2015.

#### Provision for Loan Losses

The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses as discussed within the Critical Accounting Policies section above. The allowance represents an amount that, in management's judgment, will be adequate to absorb probable losses inherent in the loan portfolio. Management's judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective because it requires estimates that are susceptible to significant revision as more information becomes available. The amount of provision for loan losses is affected by several factors including the growth rate of loans, net charge-offs, and the estimated amount of potential losses within the loan portfolio. The provision for loan losses was \$(410)

thousand and zero for the three months ended September 30, 2015 and 2014, respectively. The provision for loan losses was \$23 thousand and zero for the nine months ended September 30, 2015 and 2014, respectively. The negative provision for loan losses for the three months ended September 30, 2015 is mainly reflective of the decreases in the historic loss estimate component of the general allocation and specific allocations. The lack of provision for loan losses for the nine months ended September 30, 2015 and the three and nine months ended September 30, 2014 is also reflective of the decreases in the historic loss estimate component of the general allocation and specific allocations. However, these decreases are offset by strong loan growth resulting in a minimal provision.

## Noninterest Income

Total noninterest income for the nine months ended September 30, 2015 and 2014 was \$7.1 million and \$4.4 million, respectively, which represents an increase of \$2.7 million or 62.02%. Total noninterest income for the three months ended September 30, 2015 and 2014 was \$3.8 million and \$1.5 million, respectively, which represents an increase of \$2.3 million or 160.01%. Management reviews the activities which generate noninterest income on an ongoing basis.

The following table provides the components of noninterest income for the three and nine months ended September 30, 2015 and 2014, which are included within the respective Consolidated Statements of Income headings. Variances that the Company believes require explanation are discussed below the table.

| (dollars in thousands)                              | Three Months Ended<br>September 30, |         |           |          | Nine Months Ended<br>September 30, |         |           |          |    |
|---|-------------------------------------|---------|-----------|----------|------------------------------------|---------|-----------|----------|----|
|   | 2015                                | 2014    | \$ Change | % Change | 2015                               | 2014    | \$ Change | % Change |    |
| Income from fiduciary activities                    | \$319                               | \$212   | \$107     | 50       | %\$1,103                           | \$873   | \$230     | 26       | %  |
| Service charges on deposit accounts                 | 329                                 | 332     | (3)       | (1)      | %926                               | 984     | (58)      | (6)      | %  |
| Other service charges and fees                      | 919                                 | 827     | 92        | 11       | %2,605                             | 2,307   | 298       | 13       | %  |
| Gain on sale of securities                          | 20                                  | 87      | (67)      | NM       | 116                                | 93      | 23        | NM       |    |
| Gain on redemption of trust preferred capital notes | 2,424                               | —       | 2,424     | NM       | 2,424                              | —       | 2,424     | NM       |    |
| Other operating (loss) income                       | (181)                               | )15     | (196)     | (1,307)  | %)71                               | )127    | (198)     | (156)    | %) |
| Total noninterest income                            | \$3,830                             | \$1,473 | \$2,357   | 160      | %)\$7,103                          | \$4,384 | \$2,719   | 62       | %  |

NM - Not Meaningful

Income from fiduciary activities, generated by trust services offered through Eagle Investment Group, a division of the Bank, increased \$107 thousand or 50.47% from \$212 thousand during the three months ended September 30, 2014 to \$319 thousand during the three months ended September 30, 2015. Income from fiduciary activities increased \$230 thousand or 26.35% from \$873 thousand during the nine months ended September 30, 2014 to \$1.1 million during the nine months ended September 30, 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.

Other service charges and fees increased \$92 thousand or 11.12% from \$827 thousand during the three months ended September 30, 2014 to \$919 thousand during the three months ended September 30, 2015. Other service charges and fees increased \$298 thousand or 12.92% from \$2.3 million during the nine months ended September 30, 2014 to \$2.6 million during the nine months ended September 30, 2015. The amount of other service 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. This increase can mostly be attributed to increased activity in non-deposit investment products.

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 (loss) income experienced a decline during the three months ended September 30, 2015 and nine months ended September 30, 2015 due mainly to the derecognition of the Company's cash flow hedge and the subsequent fair value adjustment of the interest rate swap. During the third quarter, 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 as of September 30, 2015 for a gain of \$30 thousand.

## Noninterest Expenses

Total noninterest expenses increased \$185 thousand or 3.47% from \$5.3 million to \$5.5 million for the three months ended September 30, 2014 compared to the three months ended September 30, 2015. Total noninterest expenses increased \$1.6 million or 10.34% from \$15.1 million to \$16.7 million for the nine months ended September 30, 2014 compared to the nine months ended September 30, 2015. The majority of this increase results from the hiring of new employees and the expenses related to branching efforts. In addition, the company experienced a \$520 thousand one-time expense resulting from the adjustment to the purchase price of land acquired in June 2015. On June 10, 2015, the Company purchased the land, subject to the existing lease, and recorded the excess of the purchase price over the fair value of the land as a cost to terminate the operating lease.

The efficiency ratio of the Company was 72.26% and 67.51% for the nine months ended September 30, 2015 and 2014. The efficiency ratio is not a measurement under accounting principles generally accepted in the United States. It is calculated by dividing noninterest expense by the sum of tax equivalent net interest income and noninterest income excluding gains and losses on the investment portfolio. The tax rate utilized is 34%.

The following table presents the components of noninterest expense for the three and nine months ended September 30, 2015 and 2014, which are included within the respective Consolidated Statements of Income headings.

| (dollars in thousands)                             | Three Months Ended<br>September 30, |         |           |          | Nine Months Ended<br>September 30, |          |           |          |   |
|--|-------------------------------------|---------|-----------|----------|------------------------------------|----------|-----------|----------|---|
|  | 2015                                | 2014    | \$ Change | % Change | 2015                               | 2014     | \$ Change | % Change |   |
| Salaries and employee benefits                     | \$3,090                             | \$3,017 | \$73      | 2        | % \$9,197                          | \$8,768  | \$429     | 5        | % |
| Occupancy expenses                                 | 394                                 | 319     | 75        | 24       | % 1,176                            | 963      | 213       | 22       | % |
| Equipment expenses                                 | 312                                 | 197     | 115       | 58       | % 718                              | 546      | 172       | 32       | % |
| Advertising and marketing expenses                 | 155                                 | 159     | (4)       | (3)      | % 458                              | 417      | 41        | 10       | % |
| Stationary and supplies                            | 67                                  | 74      | (7)       | (9)      | % 179                              | 238      | (59)      | (25)     | % |
| ATM network fees                                   | 246                                 | 174     | 72        | 41       | % 595                              | 532      | 63        | 12       | % |
| Other real estate owned expense                    | 63                                  | 4       | 59        | 1,475    | % 83                               | 14       | 69        | 493      | % |
| (Gain) loss on the sale of other real estate owned | (11)                                | ) 14    | (25)      | ) NM     | 81                                 | (3)      | ) 84      | NM       |   |
| FDIC assessment                                    | 108                                 | 94      | 14        | 15       | % 319                              | 261      | 58        | 22       | % |
| Computer software expense                          | 134                                 | 252     | (118)     | (47)     | % 547                              | 664      | (117)     | (18)     | % |
| Bank franchise tax                                 | 131                                 | 123     | 8         | 7        | % 374                              | 342      | 32        | 9        | % |
| Professional fees                                  | 211                                 | 290     | (79)      | (27)     | % 714                              | 761      | (47)      | (6)      | % |
| Cost to terminate operating lease                  | —                                   | —       | —         | —        | % 520                              | —        | 520       | 100      | % |
| Other operating expenses                           | 618                                 | 616     | 2         | —        | % 1,746                            | 1,639    | 107       | 7        | % |
| Total noninterest expenses                         | \$5,518                             | \$5,333 | \$185     | 3        | % \$16,707                         | \$15,142 | \$1,565   | 10       | % |

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.

Computer software expense has decreased during the three and nine months ended September 30, 2015 over 2014, despite the increase in number of branches and employees. Fees paid to our core software provider have decreased from 2015 to 2014 due to a conscious effort to reduce unused services and renegotiate contract amounts.

## Income Taxes

Income tax expense was \$2.1 million and \$1.9 million during the nine months ended September 30, 2015 and 2014, respectively. The effective tax rate was 27.57% and 28.46% for the nine months ended September 30, 2015 and 2014, respectively. The difference between the effective tax rate and statutory income tax rate can be primarily attributed to tax-exempt interest earned on certain securities and loans as well as tax credits.

## FINANCIAL CONDITION

### Securities

Total securities available for sale were \$101.2 million at September 30, 2015, compared to \$94.2 million at December 31, 2014. This represents an increase of \$7.0 million or 7.45%. The Company purchased \$21.3 million in securities during the nine months ended September 30, 2015. The Company had total maturities and principal repayments of \$10.6 million. There were \$3.4 million in sales during the nine months ended September 30, 2015. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity at September 30, 2015. Note 4 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio at September 30, 2015 and December 31, 2014. The Company had a net unrealized gain on available for sale securities of \$2.1 million at September 30, 2015 as compared to a net unrealized gain of \$2.2 million at December 31, 2014. Unrealized gains or losses on available for sale securities are reported within shareholders' equity, net of the related deferred tax effect, as accumulated other comprehensive income.

### Loan Portfolio

The Company's primary use of funds is supporting lending activities from which it derives the greatest amount of interest income. Gross loans were \$491.2 million and \$469.8 million at September 30, 2015 and December 31, 2014, respectively. This represents an increase of \$21.4 million or 4.55% during the nine months ended September 30, 2015. The ratio of gross loans to deposits decreased slightly during the nine months ended September 30, 2015 from 93.25% at December 31, 2014 to 93.06% at September 30, 2015.

The loan portfolio consists primarily of loans for owner-occupied single family dwellings, loans secured by commercial real estate, and residential and commercial construction loans. Note 5 to the Consolidated Financial Statements provides the composition of the loan portfolio at September 30, 2015 and December 31, 2014.

Loans secured by real estate were \$448.0 million or 91.20% and \$425.5 million or 90.57% of total loans at September 30, 2015 and December 31, 2014, respectively. This represents an increase of \$22.5 million or 5.29% during the nine months ended September 30, 2015. Consumer installment loans were \$13.6 million or 2.77% and \$13.9 million or 2.95% of total loans at September 30, 2015 and December 31, 2014, respectively. This represents a decrease of \$258 thousand or 1.86% during the nine months ended September 30, 2015. Commercial and industrial loans were \$27.4 million or 5.58% and \$28.1 million or 5.99% of total loans at September 30, 2015 and December 31, 2014, respectively. This represents a decrease of \$714 thousand or 2.54% for the nine months ended September 30, 2015.

### Allowance for Loan Losses

The purpose of, and the methods for, measuring the allowance for loan losses are discussed in the Critical Accounting Policies section above. Note 5 to the Consolidated Financial Statements shows the activity within the allowance for loan losses during the nine months ended September 30, 2015 and 2014 and the year ended December 31, 2014. Charged-off loans were \$438 thousand and \$515 thousand for the nine months ended September 30, 2015 and 2014, respectively. Recoveries were \$499 thousand and \$614 thousand for the nine months ended September 30, 2015 and 2014, respectively. This resulted in net recoveries of \$61 thousand and \$99 thousand for the nine months ended September 30, 2015 and 2014, respectively. The allowance for loan losses as a percentage of loans was 1.05% at September 30, 2015 and 1.08% at December 31, 2014. The allowance for loan losses was 68.65% of nonperforming assets at September 30, 2015 and 39.62% of nonperforming assets at December 31, 2014. Nonperforming assets decreased by \$5.3 million during the nine months ended September 30, 2015 due mainly to decreases in nonaccrual loans. Management believes that the allowance for loan losses is currently adequate to absorb probable losses inherent in the loan portfolio. Given the uncertainty in the economic environment, there is a potential for increases in past due loans, nonperforming loans and other real estate owned. However, the Company believes that the allowance for loan losses will be maintained at a level adequate to mitigate any negative impact resulting from such increases.

## Nonperforming Assets and Other Assets

Nonperforming assets consist of nonaccrual loans, repossessed assets, other real estate owned (foreclosed properties), and loans past due 90 days or more and still accruing. Nonaccrual loans were \$5.7 million and \$10.7 million at September 30, 2015 and December 31, 2014, respectively. Other real estate owned and repossessed assets were \$1.8 million and \$2.1 million at September 30, 2015 and December 31, 2014, respectively. The Company held seven other real estate assets with an average balance of \$264 thousand at September 30, 2015. At December 31, 2014, the company held nine other real estate assets with an average balance of \$234 thousand. The percentage of nonperforming assets to loans and other real estate owned was 1.53% at September 30, 2015 and 2.72% at December 31, 2014, respectively. There were \$1 thousand in loans past due 90 days or more and still accruing interest at September 30, 2015. Total loans past due 90 days or more and still accruing interest were \$6 thousand at December 31, 2014. Loans past due 30 days or more increased \$3.6 million between December 31, 2014 and September 30, 2015. The majority of this increase was due to a few large balance loans and is not necessarily indicative of future trends in nonperforming assets.

During the nine months ended September 30, 2015, the Bank placed four loans totaling \$814 thousand on nonaccrual status. These loans are secured by real estate. Management evaluates the financial condition of these borrowers and the value of any collateral on these loans. The results of these evaluations are used to estimate the amount of losses which may be realized on the disposition of these nonaccrual loans.

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

For real estate loans, upon foreclosure, the balance of the loan is transferred to "Other Real Estate Owned" ("OREO") and carried at the fair market value of the property based on current appraisals and other current market trends, less estimated selling costs. If a write down of the OREO property is necessary at the time of foreclosure, the amount is charged-off to the allowance for loan losses. A review of the recorded property value is performed in conjunction with normal loan reviews, and if market conditions indicate that the recorded value exceeds the fair 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. However, restructured loans are not necessarily considered nonperforming assets. At September 30, 2015, the Company had \$7.8 million in restructured loans with specific allowances totaling \$478 thousand. At December 31, 2014, the Company had \$7.8 million in restructured loans with specific allowances totaling \$352 thousand. At September 30, 2015 and December 31, 2014, total restructured loans performing under the restructured terms and accruing interest were \$7.5 million and \$6.3 million, respectively. Two loans, totaling \$340 thousand, were in nonaccrual status at September 30, 2015. Eight loans, totaling \$1.4 million, were in nonaccrual status at December 31, 2014.

## Deposits

Total deposits were \$527.9 million and \$503.8 million at September 30, 2015 and December 31, 2014, respectively. This represents an increase of \$24.1 million or 4.77% during the nine months ended September 30, 2015. Note 7 to the Consolidated Financial Statements provides the composition of total deposits at September 30, 2015 and December 31, 2014.

Noninterest-bearing demand deposits which are comprised of checking accounts, increased \$17.6 million or 11.08% from \$159.4 million at December 31, 2014 to \$177.0 million at September 30, 2015. Savings and interest-bearing demand deposits, which include NOW accounts, money market accounts and regular savings accounts increased \$5.8 million or 2.34% from \$249.3 million at December 31, 2014 to \$255.1 million at September 30, 2015. Time deposits increased \$572 thousand or 0.60% from \$95.2 million at December 31, 2014 to \$95.7 million at September 30, 2015. This is comprised of an increase in time deposits of \$250,000 and more of \$4.1 million or 44.16% and a decrease in time deposits of less than \$250,000 of \$3.5 million or 4.09%. Certificates of deposit also included \$12.9 million in brokered certificates of deposit at September 30, 2015 and December 31, 2014.

## CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity at September 30, 2015 was \$77.6 million, reflecting a percentage of total assets of 11.97%, as compared to \$73.1 million and 11.62% at December 31, 2014. During the nine months ended September 30, 2014 and 2015, the Company declared dividends of \$0.57 and \$0.60 per share, respectively. The Company has a Dividend Investment Plan that reinvests the dividends of the shareholder in Company stock.

The new Basel III rules, effective January 1, 2015, changed the components of regulatory capital and changed the way in which risk ratings are assigned to various categories of bank assets. Also, a new Tier I common risk-based ratio was defined. The new rules resulted in only minor changes to the Company's Tier I and Total risk-based capital, and increased risk-weighted assets due to higher risk weightings for short-term loan commitments and past due and nonaccrual loans. Under the Basel III requirements, at September 30, 2015, the Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions. Federal regulatory risk-based capital guidelines require percentages to be applied to various assets, including off-balance sheet assets, based on their perceived risk in order to calculate risk-weighted assets. Tier 1 capital consists of total shareholders' equity plus qualifying trust preferred securities outstanding less net unrealized gains and losses on available for sale securities. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses and any excess trust preferred securities that do not qualify as Tier 1 capital.

At December 31, 2014, the \$7.0 million in trust preferred securities, issued by the Company during 2007, qualified as Tier 1 capital because this amount did not exceed 25% of total capital, including the trust preferred securities. Under the changes to the regulatory capital framework that were approved on July 9, 2013 by the federal banking agencies (Basel III Final Rule), the Company's trust preferred securities continued to be included in Tier 1 capital and total capital, pursuant to a "grandfathering" provision that exempts the Company's securities from the more stringent regulatory capital treatment contained in the Basel III Final Rule for trust preferred securities. As discussed in Note 9 to the Consolidated Financial Statements, the pool to which the Company's \$7.0 million in outstanding trust preferred capital notes belonged was liquidated by means of auction. The Company was successful in purchasing the outstanding notes, which resulted in this amount no longer being outstanding and included in Tier 1 capital beginning in the third quarter of 2015. This transaction did not cause the Company to fall below the well capitalized regulatory minimum.

For capital adequacy purposes, during 2015, financial institutions must maintain a Tier 1 common equity risk-based capital ratio of 4.50%, a Tier 1 risk-based capital ratio of at least 6.00%, a Total risk-based capital ratio of at least 8.00% and a minimum Tier 1 leverage ratio of 4.00%. The Company's policy requires a Tier 1 common equity risk-based capital ratio of 7.00%, a Tier 1 risk-based capital ratio of at least 8.50%, a total risk-based capital ratio of at least 10.50% and a minimum Tier 1 leverage ratio of 6.50%. The Company's Tier 1 common risk-based capital ratio was 15.29% at September 30, 2015. The Company's Tier 1 risk-based capital ratio was 15.29% at September 30, 2015 as compared to 17.90% at December 31, 2014. The Company's total risk-based capital ratio was 16.33% at September 30, 2015 as compared to 19.06% at December 31, 2014. The Company's Tier 1 capital to average total assets ratio was 12.00% at September 30, 2015 as compared to 12.86% at December 31, 2014. The Company monitors these ratios on a quarterly basis and has several strategies, including without limitation the issuance of common stock, to ensure that these ratios remain above regulatory minimums.

## LIQUIDITY

Liquidity management involves meeting the present and future financial obligations of the Company with the sale or maturity of assets or with the occurrence of additional liabilities. Liquidity needs are met with cash on hand, deposits in banks, federal funds sold, securities classified as available for sale and loans maturing within one year. At September 30, 2015, liquid assets totaled \$218.5 million as compared to \$219.2 million at December 31, 2014. These



amounts represent 38.99% and 39.59% of total liabilities at September 30, 2015 and December 31, 2014, respectively. The Company minimizes liquidity demand by utilizing core deposits to fund asset growth. Securities provide a constant source of liquidity through paydowns and maturities. Also, the Company maintains short-term borrowing arrangements, namely federal funds lines of credit, with larger financial institutions as an additional source of liquidity. Finally, the Bank's membership with the Federal Home Loan Bank of Atlanta provides a source of borrowings with numerous rate and term structures. The Company's senior management monitors the liquidity position regularly and attempts to maintain a position which utilizes available funds most efficiently.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in Quantitative and Qualitative Disclosures about Market Risk as reported in the 2014 Form 10-K.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of September 30, 2015 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

Management is also responsible for establishing and maintaining adequate internal control over the Company's financial reporting (as defined in Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934, as amended). The Company is currently using the 2013 COSO Framework.

There were no changes in the Company's internal control over financial reporting during the Company's quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2014.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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Item 6. Exhibits

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

| Exhibit No. | Description  |
|-------------|--|
| 31.1        | Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2        | Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 32.1        | Certification by Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101         | The following materials from the Eagle Financial Service, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2015 formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income (iv) Consolidated Statements of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) notes to Consolidated Financial Statements. |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, this 13th day of November, 2015.

Eagle Financial Services, Inc.

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

By: /S/ KATHLEEN J. CHAPPELL  
Kathleen J. Chappell  
Vice President, Chief Financial Officer

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