

EAGLE FINANCIAL SERVICES INC  
Form 10-Q  
August 14, 2013

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 June 30, 2013

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 July 23, 2013 was 3,388,005.



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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(dollars in thousands, except share amounts)

|  | June 30,<br>2013<br>(Unaudited) | December 31,<br>2012 |
|--|---------------------------------|----------------------|
| Assets   |                                 |                      |
| Cash and due from banks  | \$9,467                         | \$9,782              |
| Interest-bearing deposits with other institutions  | 1,165                           | 38,908               |
| Total cash and cash equivalents  | 10,632                          | 48,690               |
| Securities available for sale, at fair value   | 106,503                         | 102,754              |
| Restricted investments   | 2,642                           | 2,777                |
| Loans  | 436,357                         | 418,097              |
| Allowance for loan losses  | (6,978                          | ) (6,577             |
| Net Loans  | 429,379                         | 411,520              |
| Bank premises and equipment, net   | 17,287                          | 16,545               |
| Other real estate owned, net of allowance  | 2,630                           | 2,928                |
| Other assets   | 16,600                          | 8,062                |
| Total assets   | \$585,673                       | \$593,276            |
| Liabilities and Shareholders' Equity   |                                 |                      |
| Liabilities  |                                 |                      |
| Deposits:  |                                 |                      |
| Noninterest bearing demand deposits  | \$ 135,802                      | \$ 134,871           |
| Savings and interest bearing demand deposits   | 234,430                         | 231,249              |
| Time deposits  | 103,080                         | 110,981              |
| Total deposits   | \$473,312                       | \$477,101            |
| Federal funds purchased and securities sold under agreements to repurchase                                   | 5,616                           | 10,000               |
| Federal Home Loan Bank advances  | 32,250                          | 32,250               |
| Trust preferred capital notes  | 7,217                           | 7,217                |
| Other liabilities  | 2,860                           | 3,002                |
| Total liabilities  | \$521,255                       | \$529,570            |
| Shareholders' Equity   |                                 |                      |
| Preferred stock, \$10 par value; 500,000 shares authorized and unissued                                      | \$—                             | \$—                  |
| Common stock, \$2.50 par value; authorized 10,000,000 shares; issued 2013, 3,366,954; issued 2012, 3,336,022 | 8,417                           | 8,340                |
| Surplus  | 10,935                          | 10,424               |
| Retained earnings  | 44,018                          | 41,494               |
| Accumulated other comprehensive income   | 1,048                           | 3,448                |
| Total shareholders' equity   | \$64,418                        | \$63,706             |
| Total liabilities and shareholders' equity   | \$585,673                       | \$593,276            |
| See Notes to Consolidated Financial Statements   |                                 |                      |

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EAGLE FINANCIAL SERVICES, INC.

Consolidated Statements of Income (Unaudited)

(dollars in thousands, except per share amounts)

|  | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |          |
|--|--------------------------------|---------|------------------------------|----------|
|  | 2013                           | 2012    | 2013                         | 2012     |
| Interest and Dividend Income   |                                |         |                              |          |
| Interest and fees on loans   | \$5,343                        | \$5,748 | \$10,674                     | \$11,423 |
| Interest and dividends on securities available for sale:                               |                                |         |                              |          |
| Taxable interest income  | 518                            | 554     | 1,065                        | 1,152    |
| Interest income exempt from federal income taxes                                       | 314                            | 351     | 638                          | 711      |
| Dividends  | 42                             | 107     | 109                          | 210      |
| Interest on deposits in banks  | 6                              | 2       | 15                           | 5        |
| Total interest and dividend income   | \$6,223                        | \$6,762 | \$12,501                     | \$13,501 |
| Interest Expense   |                                |         |                              |          |
| Interest on deposits   | 288                            | 397     | 614                          | 841      |
| Interest on federal funds purchased and securities sold under agreements to repurchase | 1                              | 89      | 29                           | 180      |
| Interest on Federal Home Loan Bank advances  | 273                            | 273     | 543                          | 571      |
| Interest on trust preferred capital notes  | 33                             | 37      | 67                           | 75       |
| Interest on interest rate swap   | 45                             | 42      | 90                           | 83       |
| Total interest expense   | \$640                          | \$838   | \$1,343                      | \$1,750  |
| Net interest income  | \$5,583                        | \$5,924 | \$11,158                     | \$11,751 |
| Provision For Loan Losses  | 384                            | 300     | 767                          | 600      |
| Net interest income after provision for loan losses                                    | \$5,199                        | \$5,624 | \$10,391                     | \$11,151 |
| Noninterest Income   |                                |         |                              |          |
| Income from fiduciary activities   | \$273                          | \$281   | \$633                        | \$521    |
| Service charges on deposit accounts  | 366                            | 370     | 709                          | 722      |
| Other service charges and fees   | 1,443                          | 868     | 2,243                        | 1,678    |
| Gain on sale of securities   | 10                             | 14      | 400                          | 14       |
| Other operating income   | 377                            | 40      | 416                          | 108      |
| Total noninterest income   | \$2,469                        | \$1,573 | \$4,401                      | \$3,043  |
| Noninterest Expenses   |                                |         |                              |          |
| Salaries and employee benefits   | \$2,910                        | \$2,671 | \$5,551                      | \$5,284  |
| Occupancy expenses   | 319                            | 287     | 600                          | 579      |
| Equipment expenses   | 191                            | 176     | 346                          | 340      |
| Advertising and marketing expenses   | 144                            | 100     | 271                          | 215      |
| Stationery and supplies  | 68                             | 69      | 146                          | 140      |
| ATM network fees   | 143                            | 135     | 300                          | 257      |
| Other real estate owned expense  | 20                             | 29      | 28                           | 50       |
| (Gain) loss on the sale of other real estate owned                                     | (53)                           | (4)     | (53)                         | (15)     |
| FDIC assessment  | 96                             | (77)    | 193                          | 106      |
| Computer software expense  | 164                            | 101     | 319                          | 236      |
| Bank franchise tax   | 101                            | 95      | 202                          | 196      |
| Professional fees  | 284                            | 259     | 525                          | 520      |
| Other operating expenses   | 565                            | 539     | 1,107                        | 1,074    |
| Total noninterest expenses   | \$4,952                        | \$4,380 | \$9,535                      | \$8,982  |
| Income before income taxes   | \$2,716                        | \$2,817 | \$5,257                      | \$5,212  |

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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Income Tax Expense                             | 715     | 815     | 1,453   | 1,496   |
| Net income                                     | \$2,001 | \$2,002 | \$3,804 | \$3,716 |
| Earnings Per Share                             |         |         |         |         |
| Net income per common share, basic             | \$0.59  | \$0.60  | \$1.13  | \$1.12  |
| Net income per common share, diluted           | \$0.59  | \$0.60  | \$1.12  | \$1.12  |
| See Notes to Consolidated Financial Statements |         |         |         |         |

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## EAGLE FINANCIAL SERVICES, INC.

## Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

(dollars in thousands)

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |         |   |
|--|--------------------------------|-----------|------------------------------|---------|---|
|  | 2013                           | 2012      | 2013                         | 2012    |   |
| Net income   | \$2,001                        | \$2,002   | \$3,804                      | \$3,716 |   |
| Other comprehensive (loss) income:   |                                |           |                              |         |   |
| Unrealized (loss) gain on available for sale securities, net of deferred income taxes (benefit) of (\$1,149) and \$200 for the three months ended June 30, 2013 and 2012, respectively and (\$1,292) and \$287 for the six months ended June 30, 2013 and 2012, respectively | (2,230                         | ) 386     | (2,508                       | ) 556   |   |
| Change in fair value of interest rate swap, net of deferred income taxes (benefit) of \$40 and (\$25) for the three months ended June 30, 2013 and 2012, respectively and \$56 and (\$18) for the six months ended June 30, 2013 and 2012, respectively                      | 77                             | (47       | ) 108                        | (35     | ) |
| Total other comprehensive (loss) income  | (2,153                         | ) 339     | (2,400                       | ) 521   |   |
| Total comprehensive (loss) income  | \$(152                         | ) \$2,341 | \$1,404                      | \$4,237 |   |
| See Notes to Consolidated Financial Statements   |                                |           |                              |         |   |

## EAGLE FINANCIAL SERVICES, INC.

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

|   | Common<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total    |
|---|-----------------|----------|----------------------|---|----------|
| Balance, December 31, 2011  | \$8,217         | \$9,568  | \$37,374             | \$ 2,931  | \$58,090 |
| Net income  |                 |          | 3,716                |   | 3,716    |
| Other comprehensive income  |                 |          |                      | 521   | 521      |
| Restricted stock awards, stock incentive<br>plan (7,363 shares)       | 19              | (19 )    |                      |   | —        |
| Income tax benefit on vesting of<br>restricted stock                  |                 | 2        |                      |   | 2        |
| Stock-based compensation expense                                      |                 | 90       |                      |   | 90       |
| Issuance of common stock, dividend<br>investment plan (16,696 shares) | 42              | 266      |                      |   | 308      |
| Issuance of common stock, employee<br>benefit plan (6,099 shares)     | 15              | 91       |                      |   | 106      |
| Dividends declared (\$0.36 per share)                                 |                 |          | (1,194 )             |   | (1,194 ) |
| Balance, June 30, 2012  | \$8,293         | \$9,998  | \$39,896             | \$ 3,452  | \$61,639 |
| Balance, December 31, 2012  | \$8,340         | \$10,424 | \$41,494             | \$ 3,448  | 63,706   |
| Net income  |                 |          | 3,804                |   | 3,804    |
| Other comprehensive (loss)  |                 |          |                      | (2,400 )  | (2,400 ) |
| Restricted stock awards, stock incentive<br>plan (9,699 shares)       | 24              | (24 )    |                      |   | —        |
| Income tax benefit on vesting of<br>restricted stock                  |                 | 18       |                      |   | 18       |
| Stock-based compensation expense                                      |                 | 116      |                      |   | 116      |
| Issuance of common stock, dividend<br>investment plan (15,139 shares) | 38              | 290      |                      |   | 328      |
| Issuance of common stock, employee<br>benefit plan (6,094 shares)     | 15              | 111      |                      |   | 126      |
| Dividends declared (\$0.38 per share)                                 |                 |          | (1,280 )             |   | (1,280 ) |
| Balance, June 30, 2013  | \$8,417         | \$10,935 | \$44,018             | \$ 1,048  | \$64,418 |
| See Notes to Consolidated Financial Statements                        |                 |          |                      |   |          |



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

|  | Six Months Ended |             |
|--|------------------|-------------|
|  | June 30,         |             |
|  | 2013             | 2012        |
| Cash Flows from Operating Activities   |                  |             |
| Net income   | \$3,804          | \$3,716     |
| Adjustments to reconcile net income to net cash provided by operating activities:            |                  |             |
| Depreciation   | 387              | 422         |
| Amortization of intangible and other assets  | 76               | 56          |
| Provision for loan losses  | 767              | 600         |
| (Gain) on the sale of other real estate owned  | (53)             | ) (15)      |
| Loss on the sale and disposal of assets  | 2                | 2           |
| (Gain) on the sale of securities   | (400)            | ) (14)      |
| Accrual of restricted stock awards   | 116              | 90          |
| Premium amortization on securities, net  | 74               | 99          |
| Deferred tax benefit   | 876              | —           |
| Changes in assets and liabilities:   |                  |             |
| (Increase) in other assets   | (8,243           | ) (1,410)   |
| Increase in other liabilities  | 23               | 1,642       |
| Net cash (used in) provided by operating activities  | \$(2,571         | ) \$5,188   |
| Cash Flows from Investing Activities   |                  |             |
| Proceeds from maturities and principal payments of securities available for sale             | \$11,781         | \$11,138    |
| Proceeds from the sale of securities available for sale                                      | 2,756            | 1,571       |
| Purchases of securities available for sale   | (21,760          | ) (2,157)   |
| Proceeds from the sale of restricted securities  | 136              | 577         |
| Purchases of bank premises and equipment   | (1,130           | ) (1,593)   |
| Proceeds from the sale of other real estate owned  | 351              | 800         |
| Proceeds from the sale of repossessed assets   | 11               | 53          |
| Net (increase) in loans  | (18,632          | ) (19,394)  |
| Net cash (used in) investing activities  | \$(26,487        | ) \$(9,005) |
| Cash Flows from Financing Activities   |                  |             |
| Net increase in demand deposits, money market and savings accounts                           | \$4,111          | \$19,076    |
| Net (decrease) in certificates of deposit  | (7,901           | ) (13,424)  |
| Net (decrease) in federal funds purchased and securities sold under agreements to repurchase | (4,384           | ) —         |
| Net (decrease) in Federal Home Loan Bank advances  | —                | (10,000)    |
| Issuance of common stock, employee benefit plan  | 126              | 106         |
| Cash dividends paid  | (952             | ) (886)     |
| Net cash (used in) financing activities  | \$(9,000         | ) \$(5,128) |



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

|  | Six Months Ended |            |   |
|--|------------------|------------|---|
|  | June 30,         |            |   |
|  | 2013             | 2012       | ) |
| (Decrease) in cash and cash equivalents                              | \$(38,058        | ) \$(8,945 | ) |
| Cash and Cash Equivalents  |                  |            |   |
| Beginning  | 48,690           | 21,941     |   |
| Ending   | \$10,632         | \$12,996   |   |
| Supplemental Disclosures of Cash Flow Information                    |                  |            |   |
| Cash payments for:   |                  |            |   |
| Interest   | \$1,426          | \$1,798    |   |
| Income taxes   | \$1,622          | \$1,445    |   |
| Supplemental Schedule of Noncash Investing and Financing Activities: |                  |            |   |
| Unrealized (loss) gain on securities available for sale              | \$(3,800         | ) \$843    | ) |
| Change in fair value of interest rate swap                           | \$164            | \$(53      | ) |
| Other real estate acquired in settlement of loans                    | \$—              | \$579      |   |
| Issuance of common stock, dividend investment plan                   | \$328            | \$308      |   |

EAGLE FINANCIAL SERVICES, INC.

Notes to Consolidated Financial Statements (Unaudited)

June 30, 2013

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 June 30, 2013 and December 31, 2012, the results of operations for the three and six months ended June 30, 2013 and 2012, and cash flows for the six months ended June 30, 2013 and 2012. The results of operations for the three and six months ended June 30, 2013 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, 2012 (the "2012 Form 10-K").

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

Certain amounts in the consolidated financial statements have been reclassified to conform to current year presentations.

NOTE 2. Stock-Based Compensation Plan

During 2003, the Company's shareholders approved a stock incentive plan which allows key employees and directors to increase their personal financial interest in the Company. This plan permits the issuance of incentive stock options and non-qualified stock options and the award of stock appreciation rights, common stock, restricted stock, and phantom stock. The plan authorizes the issuance of up to 300,000 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.

The following table presents Restricted Stock activity for the six months ended June 30, 2013 and 2012:

| Six Months Ended |                             |        |                             |
|------------------|-----------------------------|--------|-----------------------------|
| June 30,         |                             |        |                             |
| 2013             |                             | 2012   |                             |
| Shares           | Weighted Average Grant Date | Shares | Weighted Average Grant Date |

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|                                |        | Fair Value |        | Fair Value |
|--------------------------------|--------|------------|--------|------------|
| Nonvested, beginning of period | 16,500 | \$16.53    | 13,700 | \$16.11    |
| Granted                        | 14,900 | 22.06      | 14,500 | 17.87      |
| Vested                         | (9,699 | ) 16.47    | (7,363 | ) 16.10    |
| Forfeited                      | (651   | ) 16.75    | (737   | ) 16.25    |
| Nonvested, end of period       | 21,050 | \$20.46    | 20,100 | \$17.37    |

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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. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. The number of potential common shares is determined using the treasury method and relates to outstanding stock options and unvested restricted stock grants.

The following table shows the weighted average number of shares used in computing earnings per share for the three and six months ended June 30, 2013 and 2012 and the effect on the weighted average number of shares of dilutive potential common stock. Potential dilutive common stock had no effect on income available to common shareholders.

|  | Three Months Ended |           | Six Months Ended |           |
|--|--------------------|-----------|------------------|-----------|
|  | June 30,<br>2013   | 2012      | June 30,<br>2013 | 2012      |
| Average number of common shares outstanding  | 3,378,955          | 3,326,999 | 3,373,353        | 3,321,502 |
| Effect of dilutive common stock  | 10,109             | 8,891     | 10,395           | 8,821     |
| Average number of common shares outstanding used to calculate diluted earnings per share | 3,389,064          | 3,335,890 | 3,383,748        | 3,330,323 |

## NOTE 4. Securities

Amortized costs and fair values of securities available for sale at June 30, 2013 and December 31, 2012 were as follows:

|  | Amortized<br>Cost                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair<br>Value |
|--|-------------------------------------|------------------------------|---------------------------------|---------------|
|  | June 30, 2013<br>(in thousands)     |                              |                                 |               |
| Obligations of U.S. government corporations and agencies | \$35,485                            | \$555                        | \$(906)                         | ) \$35,134    |
| Mortgage-backed securities                               | 17,855                              | 556                          | (113)                           | ) 18,298      |
| Obligations of states and political subdivisions         | 41,652                              | 1,128                        | (324)                           | ) 42,456      |
| Corporate securities                                     | 8,474                               | 981                          | —                               | 9,455         |
| Equity securities  | 1,044                               | 116                          | —                               | 1,160         |
|  | \$104,510                           | \$3,336                      | \$(1,343)                       | ) \$106,503   |
|  | December 31, 2012<br>(in thousands) |                              |                                 |               |
| Obligations of U.S. government corporations and agencies | \$22,781                            | \$911                        | \$—                             | ) \$23,692    |
| Mortgage-backed securities                               | 20,978                              | 1,229                        | —                               | ) 22,207      |
| Obligations of states and political subdivisions         | 41,185                              | 2,327                        | (11)                            | ) 43,501      |
| Corporate securities                                     | 9,963                               | 1,193                        | —                               | 11,156        |
| Equity securities  | 2,054                               | 144                          | —                               | 2,198         |
|  | \$96,961                            | \$5,804                      | \$(11)                          | ) \$102,754   |

During the six months ended June 30, 2013, the Company sold \$2.8 million in available for sale securities for a net gain of \$400 thousand. During the six months ended June 30, 2012, the Company sold \$1.6 million in available for sale securities for a net gain of \$14 thousand.



The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at June 30, 2013 and December 31, 2012 were as follows:

|  | Less than 12 months |                         | 12 months or more |                         | Total      |                         |
|--|---------------------|-------------------------|-------------------|-------------------------|------------|-------------------------|
|  | Fair Value          | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| June 30, 2013<br>(in thousands)                          |                     |                         |                   |                         |            |                         |
| Obligations of U.S. government corporations and agencies | \$22,962            | \$906                   | \$—               | \$—                     | \$22,962   | \$906                   |
| Mortgage-backed securities                               | 3,066               | 113                     | —                 | —                       | 3,066      | 113                     |
| Obligations of states and political subdivisions         | 8,394               | 324                     | —                 | —                       | 8,394      | 324                     |
| Corporate securities                                     | —                   | —                       | —                 | —                       | —          | —                       |
| Equity securities  | —                   | —                       | —                 | —                       | —          | —                       |
|  | \$34,422            | \$1,343                 | \$—               | \$—                     | \$34,422   | \$1,343                 |
| December 31, 2012<br>(in thousands)                      |                     |                         |                   |                         |            |                         |
| Obligations of U.S. government corporations and agencies | \$—                 | \$—                     | \$—               | \$—                     | \$—        | \$—                     |
| Mortgage-backed securities                               | —                   | —                       | —                 | —                       | —          | —                       |
| Obligations of states and political subdivisions         | 495                 | 6                       | 274               | 5                       | 769        | 11                      |
| Corporate securities                                     | —                   | —                       | —                 | —                       | —          | —                       |
| Equity securities  | —                   | —                       | —                 | —                       | —          | —                       |
|  | \$495               | \$6                     | \$274             | \$5                     | \$769      | \$11                    |

Gross unrealized losses on available for sale securities included forty-five (45) and two (2) debt securities at June 30, 2013 and December 31, 2012, respectively. The Company evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The Company's mortgage-backed securities are issued by U.S. government agencies, which guarantee payments to investors regardless of the status of the underlying mortgages. Consideration is given to the length of time and the amount of an unrealized loss, the financial condition of the issuer, and the intent and ability of the Company to retain its investment in the issuer long enough to allow for an anticipated recovery in fair value. The fair value of a security reflects its liquidity as compared to similar instruments, current market rates on similar instruments, and the creditworthiness of the issuer. Absent any change in the liquidity of a security or the creditworthiness of the issuer, prices will decline as market rates rise and vice-versa. The primary cause of the unrealized losses at June 30, 2013 and December 31, 2012 was changes in market interest rates. Since the losses can be primarily attributed to changes in market interest rates and not expected cash flows or an issuer's financial condition, the unrealized losses are deemed to be temporary. The continuing economic recession involving housing, liquidity and credit were also a contributing factor to the unrealized losses on these securities at June 30, 2013 and December 31, 2012. The Company monitors the financial condition of these issuers continuously and will record other-than-temporary impairment if the recovery of value is unlikely.

The Company's securities are exposed to various risks, such as interest rate, market, currency and credit risks. Due to the level of risk associated with certain securities and the level of uncertainty related to changes in the value of securities, it is at least reasonably possible that changes in risks in the near term would materially affect securities



reported in the financial statements. In addition, recent economic uncertainty and market events have led to unprecedented volatility in currency, commodity, credit and equity markets culminating in failures of some banking and financial services firms and government intervention to solidify others. These events underscore the level of investment risk associated with the current economic environment, and accordingly the level of risk in the Company's securities.

Securities having a carrying value of \$5.2 million at June 30, 2013 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 June 30, 2013 and December 31, 2012 was as follows:

|                               | June 30, 2013  | December 31, 2012 |
|-------------------------------|----------------|-------------------|
|                               | (in thousands) |                   |
| Federal Reserve Bank Stock    | \$344          | \$344             |
| Federal Home Loan Bank Stock  | 2,158          | 2,293             |
| Community Bankers' Bank Stock | 140            | 140               |
|                               | \$2,642        | \$2,777           |

NOTE 5. Allowance for Loan Losses

Changes in the allowance for loan losses for the six months ended June 30, 2013 and 2012 and the year ended December 31, 2012 were as follows:

|  | Six Months Ended<br>June 30,<br>2013 | Year Ended<br>December 31,<br>2012 | Six Months Ended<br>June 30,<br>2012 |
|--|--------------------------------------|------------------------------------|--------------------------------------|
|  |                                      | (in thousands)                     |                                      |
| Balance, beginning                     | \$6,577                              | \$8,743                            | \$8,743                              |
| Provision charged to operating expense | 767                                  | 1,660                              | 600                                  |
| Recoveries added to the allowance      | 80                                   | 337                                | 131                                  |
| Loan losses charged to the allowance   | (446                                 | ) (4,163                           | ) (846                               |
| Balance, ending                        | \$6,978                              | \$6,577                            | \$8,628                              |

Nonaccrual and past due loans by class at June 30, 2013 and December 31, 2012 were as follows:

|                                  | June 30, 2013<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       | \$66                            | \$—                         | \$230                          | \$296             | \$20,526 | \$20,822    | \$—   | \$230               |
| Commercial Real<br>Estate:       |                                 |                             |                                |                   |          |             |   |                     |
| Owner Occupied                   | 753                             | 452                         | —                              | 1,205             | 93,660   | 94,865      | —   | 81                  |
| Non-owner occupied               | 1,022                           | 197                         | —                              | 1,219             | 51,498   | 52,717      | —   | 197                 |
| Construction and<br>Farmland:    |                                 |                             |                                |                   |          |             |   |                     |
| Residential                      | —                               | 22                          | —                              | 22                | 4,921    | 4,943       | —   | —                   |
| Commercial                       | 41                              | 42                          | —                              | 83                | 26,852   | 26,935      | —   | 121                 |
| Consumer:                        |                                 |                             |                                |                   |          |             |   |                     |
| Installment                      | 138                             | 1                           | 5                              | 144               | 13,293   | 13,437      | 5   | —                   |
| Residential:                     |                                 |                             |                                |                   |          |             |   |                     |

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|                 |         |         |       |         |           |           |       |         |
|-----------------|---------|---------|-------|---------|-----------|-----------|-------|---------|
| Equity Lines    | 310     | 21      | —     | 331     | 31,508    | 31,839    | —     | 271     |
| Single family   | 2,387   | 373     | 666   | 3,426   | 181,163   | 184,589   | 196   | 1,495   |
| Multifamily     | —       | —       | —     | —       | 2,782     | 2,782     | —     | —       |
| All Other Loans | —       | —       | —     | —       | 3,428     | 3,428     | —     | —       |
| Total           | \$4,717 | \$1,108 | \$901 | \$6,726 | \$429,631 | \$436,357 | \$201 | \$2,395 |

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December 31, 2012

(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: |                             |                             |                                |                   |           |             |   |                     |
| Commercial &<br>Industrial       | \$822                       | \$225                       | \$—                            | \$1,047           | \$20,593  | \$21,640    | \$—   | \$230               |
| Commercial Real<br>Estate:       |                             |                             |                                |                   |           |             |   |                     |
| Owner Occupied                   | 610                         | 374                         | 90                             | 1,074             | 84,090    | 85,164      | —   | 90                  |
| Non-owner occupied               | 234                         | 582                         | —                              | 816               | 38,402    | 39,218      | —   | 209                 |
| Construction and<br>Farmland:    |                             |                             |                                |                   |           |             |   |                     |
| Residential                      | —                           | —                           | —                              | —                 | 9,706     | 9,706       | —   | —                   |
| Commercial                       | 93                          | 44                          | —                              | 137               | 28,033    | 28,170      | —   | 131                 |
| Consumer:                        |                             |                             |                                |                   |           |             |   |                     |
| Installment                      | 116                         | 10                          | 9                              | 135               | 13,172    | 13,307      | 9   | —                   |
| Residential:                     |                             |                             |                                |                   |           |             |   |                     |
| Equity Lines                     | 109                         | —                           | —                              | 109               | 31,593    | 31,702      | —   | 287                 |
| Single family                    | 4,059                       | 733                         | 524                            | 5,316             | 177,601   | 182,917     | 199   | 1,467               |
| Multifamily                      | —                           | —                           | —                              | —                 | 2,808     | 2,808       | —   | —                   |
| All Other Loans                  | —                           | —                           | —                              | —                 | 3,465     | 3,465       | —   | —                   |
| Total                            | \$6,043                     | \$1,968                     | \$623                          | \$8,634           | \$409,463 | \$418,097   | \$208                                       | \$2,414             |

Allowance for loan losses by segment at June 30, 2013 and December 31, 2012 were as follows:

As of and For the Six Months Ended

June 30, 2013

(in thousands)

|   | Construction<br>and Farmland<br>Real Estate | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | All Other<br>Loans | Unallocated | Total   |
|---|---|----------------------------|---------------------------|------------|----------|--------------------|-------------|---------|
| Allowance for credit<br>losses:             |   |                            |                           |            |          |                    |             |         |
| Beginning Balance                           | \$1,280                                     | \$2,820                    | \$1,182                   | \$880      | \$107    | \$122              | \$186       | \$6,577 |
| Charge-Offs                                 | —   | (218)                      | ) —                       | (174)      | ) (43)   | ) (11)             | ) —         | (446)   |
| Recoveries                                  | 3   | 15                         | 3                         | 24         | 30       | 5                  | —           | 80      |
| Provision                                   | 28  | 304                        | 433                       | 219        | —        | (29)               | (188)       | 767     |
| Ending balance                              | \$1,311                                     | \$2,921                    | \$1,618                   | \$949      | \$94     | \$87               | \$(2)       | \$6,978 |
| Ending balance:                             |   |                            |                           |            |          |                    |             |         |
| Individually<br>evaluated for<br>impairment | \$204                                       | \$1,386                    | \$289                     | \$520      | \$—      | \$—                | \$—         | \$2,399 |
| Ending balance:                             |   |                            |                           |            |          |                    |             |         |
| collectively<br>evaluated for<br>impairment | \$1,107                                     | \$1,535                    | \$1,329                   | \$429      | \$94     | \$87               | \$(2)       | \$4,579 |

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|  |          |            |            |           |          |         |      |           |
|--|----------|------------|------------|-----------|----------|---------|------|-----------|
| Financing receivables:                               |          |            |            |           |          |         |      |           |
| Ending balance                                       | \$31,878 | \$ 219,210 | \$ 147,582 | \$ 20,822 | \$13,437 | \$3,428 | \$ — | \$436,357 |
| Ending balance individually evaluated for impairment | \$1,381  | \$ 7,208   | \$ 5,032   | \$ 681    | \$—      | \$—     | \$—  | \$14,302  |
| Ending balance collectively evaluated for impairment | \$30,497 | \$ 212,002 | \$ 142,550 | \$ 20,141 | \$13,437 | \$3,428 | \$—  | \$422,055 |

As of and for the Twelve Months Ended  
December 31, 2012  
(in thousands)

|  | Construction<br>and Farmland | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | All Other<br>Loans | Unallocated | Total     |
|--|------------------------------|----------------------------|---------------------------|------------|----------|--------------------|-------------|-----------|
| Allowance for credit losses:                         |                              |                            |                           |            |          |                    |             |           |
| Beginning Balance                                    | \$2,618                      | \$3,544                    | \$1,057                   | \$1,077    | \$131    | \$123              | \$193       | \$8,743   |
| Charge-Offs  | (1,313)                      | (1,381)                    | (1,118)                   | (207)      | (116)    | (28)               | —           | (4,163)   |
| Recoveries   | 4                            | 67                         | 146                       | 36         | 73       | 11                 | —           | 337       |
| Provision  | (29)                         | 590                        | 1,097                     | (26)       | 19       | 16                 | (7)         | 1,660     |
| Ending balance                                       | \$1,280                      | \$2,820                    | \$1,182                   | \$880      | \$107    | \$122              | \$186       | \$6,577   |
| Ending balance:                                      |                              |                            |                           |            |          |                    |             |           |
| Individually evaluated for impairment                | \$141                        | \$1,176                    | \$305                     | \$737      | \$—      | \$—                | \$—         | \$2,359   |
| Ending balance:                                      |                              |                            |                           |            |          |                    |             |           |
| collectively evaluated for impairment                | \$1,139                      | \$1,644                    | \$877                     | \$143      | \$107    | \$122              | \$186       | \$4,218   |
| Financing receivables:                               |                              |                            |                           |            |          |                    |             |           |
| Ending balance                                       | \$37,876                     | \$217,427                  | \$124,382                 | \$21,640   | \$13,307 | \$3,465            | \$—         | \$418,097 |
| Ending balance individually evaluated for impairment | \$1,326                      | \$7,695                    | \$5,246                   | \$985      | \$—      | \$—                | \$—         | \$15,252  |
| Ending balance collectively evaluated for impairment | \$36,550                     | \$209,732                  | \$119,136                 | \$20,655   | \$13,307 | \$3,465            | \$—         | \$402,845 |

Impaired loans by class at June 30, 2013 and December 31, 2012 were as follows:

|                               | As of<br>June 30, 2013<br>(in thousands) |                        |                      |                                   |                                  |
|-------------------------------|--|------------------------|----------------------|-----------------------------------|----------------------------------|
|                               | Unpaid<br>Principal<br>Balance           | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| With no related allowance:    |  |                        |                      |                                   |                                  |
| Commercial - Non Real Estate: |  |                        |                      |                                   |                                  |
| Commercial & Industrial       | \$160                                    | \$173                  | \$—                  | \$332                             | \$5                              |
| Commercial Real Estate:       |  |                        |                      |                                   |                                  |
| Owner Occupied                | 1,467                                    | 1,472                  | —                    | 1,689                             | 38                               |
| Non-owner occupied            | 2,259                                    | 2,269                  | —                    | 2,347                             | 54                               |
| Construction and Farmland:    |  |                        |                      |                                   |                                  |
| Residential                   | —  | —                      | —                    | —                                 | —                                |
| Commercial                    | 1,028                                    | 1,029                  | —                    | 1,057                             | 20                               |
| Residential:                  |  |                        |                      |                                   |                                  |
| Equity lines                  | 456                                      | 456                    | —                    | 647                               | 3                                |
| Single family                 | 2,069                                    | 2,072                  | —                    | 3,535                             | 16                               |
| Multifamily                   | —  | —                      | —                    | —                                 | —                                |
| Other Loans                   | —  | —                      | —                    | —                                 | —                                |
|                               | \$7,439                                  | \$7,471                | \$—                  | \$9,607                           | \$136                            |
| With an allowance recorded:   |  |                        |                      |                                   |                                  |
| Commercial - Non Real Estate: |  |                        |                      |                                   |                                  |
| Commercial & Industrial       | \$521                                    | \$521                  | \$521                | \$574                             | \$9                              |
| Commercial Real Estate:       |  |                        |                      |                                   |                                  |
| Owner Occupied                | —  | —                      | —                    | —                                 | —                                |
| Non-owner occupied            | 1,306                                    | 1,309                  | 289                  | 1,318                             | 33                               |
| Construction and Farmland:    |  |                        |                      |                                   |                                  |
| Residential                   | —  | —                      | —                    | —                                 | —                                |
| Commercial                    | 353                                      | 355                    | 204                  | 360                               | 8                                |
| Residential:                  |  |                        |                      |                                   |                                  |
| Equity lines                  | 220                                      | 221                    | 220                  | 216                               | 3                                |
| Single family                 | 4,463                                    | 4,478                  | 1,165                | 4,498                             | 103                              |
| Multifamily                   | —  | —                      | —                    | —                                 | —                                |
| Other Loans                   | —  | —                      | —                    | —                                 | —                                |
|                               | \$6,863                                  | \$6,884                | \$2,399              | \$6,966                           | \$156                            |
| Total:                        |  |                        |                      |                                   |                                  |
| Commercial                    | \$681                                    | \$694                  | \$521                | \$906                             | \$14                             |
| Commercial Real Estate        | 5,032                                    | 5,050                  | 289                  | 5,354                             | 125                              |
| Construction and Farmland     | 1,381                                    | 1,384                  | 204                  | 1,417                             | 28                               |
| Residential                   | 7,208                                    | 7,227                  | 1,385                | 8,896                             | 125                              |
| Other                         | —  | —                      | —                    | —                                 | —                                |
| Total                         | \$14,302                                 | \$14,355               | \$2,399              | \$16,573                          | \$292                            |

The average recorded investment of impaired loans for the second quarter of 2013 was \$16.4 million. The interest income recognized on impaired loans for the three months ended June 30, 2013 was \$139 thousand.





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

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.

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

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

Credit quality information by class at June 30, 2013 and December 31, 2012 was as follows:

| INTERNAL RISK<br>RATING GRADES   | As of<br>June 30, 2013<br>(in thousands) |           |                    |             |          |      | Total      |
|----------------------------------|--|-----------|--------------------|-------------|----------|------|------------|
|                                  | Pass                                     | Watch     | Special<br>Mention | Substandard | Doubtful | Loss |            |
| Commercial - Non Real<br>Estate: |  |           |                    |             |          |      |            |
| Commercial & Industrial          | \$ 16,560                                | \$ 2,002  | \$ 433             | \$ 1,597    | \$ 230   | \$ — | \$ 20,822  |
| Commercial Real Estate:          |  |           |                    |             |          |      |            |
| Owner Occupied                   | 80,103                                   | 8,466     | 2,364              | 3,851       | 81       | —    | 94,865     |
| Non-owner occupied               | 31,209                                   | 11,186    | 3,594              | 6,728       | —        | —    | 52,717     |
| Construction and<br>Farmland:    |  |           |                    |             |          |      |            |
| Residential                      | 4,821                                    | 122       | —                  | —           | —        | —    | 4,943      |
| Commercial                       | 20,251                                   | 2,151     | 594                | 3,939       | —        | —    | 26,935     |
| Residential:                     |  |           |                    |             |          |      |            |
| Equity Lines                     | 30,277                                   | 501       | 373                | 596         | 92       | —    | 31,839     |
| Single family                    | 151,628                                  | 12,741    | 9,961              | 9,725       | 534      | —    | 184,589    |
| Multifamily                      | 1,854                                    | 928       | —                  | —           | —        | —    | 2,782      |
| All other loans                  | 3,428                                    | —         | —                  | —           | —        | —    | 3,428      |
| Total                            | \$ 340,131                               | \$ 38,097 | \$ 17,319          | \$ 26,436   | \$ 937   | \$ — | \$ 422,920 |

|  | Performing | Nonperforming |
|--|------------|---------------|
| Consumer Credit Exposure by Payment Activity | \$13,293   | \$144         |

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| INTERNAL RISK<br>RATING GRADES               | As of<br>December 31, 2012<br>(in thousands) |           |                    |             |          |            | Total         |
|--|--|-----------|--------------------|-------------|----------|------------|---------------|
|  | Pass   | Watch     | Special<br>Mention | Substandard | Doubtful | Loss       |               |
| Commercial - Non Real<br>Estate:             |  |           |                    |             |          |            |               |
| Commercial & Industrial                      | \$ 16,132                                    | \$ 2,289  | \$ 1,099           | \$ 1,891    | \$ 229   | \$—        | \$ 21,640     |
| Commercial Real Estate:                      |  |           |                    |             |          |            |               |
| Owner Occupied                               | 72,916                                       | 6,503     | 1,737              | 3,918       | 90       | —          | 85,164        |
| Non-owner occupied                           | 22,810                                       | 5,303     | 4,332              | 6,773       | —        | —          | 39,218        |
| Construction and Farm<br>land:               |  |           |                    |             |          |            |               |
| Residential                                  | 9,548  | 158       | —                  | —           | —        | —          | 9,706         |
| Commercial                                   | 21,155                                       | 1,777     | 854                | 4,384       | —        | —          | 28,170        |
| Residential:                                 |  |           |                    |             |          |            |               |
| Equity Lines                                 | 30,165                                       | 426       | 172                | 843         | 96       | —          | 31,702        |
| Single family                                | 148,904                                      | 12,048    | 10,672             | 10,780      | 513      | —          | 182,917       |
| Multifamily                                  | 1,905  | 903       | —                  | —           | —        | —          | 2,808         |
| All other loans                              | 3,465  | —         | —                  | —           | —        | —          | 3,465         |
| Total  | \$ 327,000                                   | \$ 29,407 | \$ 18,866          | \$ 28,589   | \$ 928   | \$—        | \$ 404,790    |
|  |  |           |                    |             |          | Performing | Nonperforming |
| Consumer Credit Exposure by Payment Activity |  |           |                    |             |          | \$ 13,172  | \$ 135        |

## 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 Bank has granted a concession (one or multiple items may be present):

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

There were twenty-three (23) troubled debt restructured loans totaling \$8.1 million at June 30, 2013. At December 31, 2012, there were twenty-three (23) troubled debt restructured loans totaling \$8.2 million. There were no outstanding commitments to lend additional amounts to troubled debt restructured borrowers at June 30, 2013.

The following tables set forth information on the Company's troubled debt restructurings by class of financing receivable occurring during the three and six months ended June 30, 2013 and June 30, 2012:

|  |  | Three Months Ended<br>June 30, 2013<br>(in thousands)     |  |                       |
|--|--|---|--|-----------------------|
|  |  | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Impairment<br>Accrued |
| Number of<br>Contracts                   |  |   |  |                       |
| 0  |  | \$—   | \$—  | \$—                   |
| 0  |  | \$—   | \$—  | \$—                   |
|  |  | Three Months Ended<br>June 30, 2012<br>(in thousands)     |  |                       |
|  |  | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Impairment<br>Accrued |
| Number of<br>Contracts                   |  |   |  |                       |
| Commercial Real Estate<br>Owner Occupied |  |   |  |                       |
| 1  |  | \$ 162  | \$ 162   | \$—                   |
| 1  |  | \$ 162  | \$ 162   | \$—                   |
|  |  | Six Months Ended<br>June 30, 2013<br>(in thousands)       |  |                       |
|  |  | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Impairment<br>Accrued |
| Number of<br>Contracts                   |  |   |  |                       |
| Residential<br>Equity lines              |  |   |  |                       |
| 1  |  | \$ 184  | \$ 184   | \$—                   |
| Total                                    |  | \$ 184  | \$ 184   | \$—                   |
|  |  | Six Months Ended<br>June 30, 2012<br>(in thousands)       |  |                       |
|  |  | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Impairment<br>Accrued |
| Number of<br>Contracts                   |  |   |  |                       |
| Commercial Real Estate<br>Owner Occupied |  |   |  |                       |
| 1  |  | \$ 162  | \$ 162   | \$—                   |
| Residential<br>Single family             |  |   |  |                       |
| 1  |  | 91  | 91   | —                     |
| Total                                    |  | \$ 253  | \$ 253   | \$—                   |

During the three months ended June 30, 2013 , the Company had no new restructured loans. During the six months ended June 30, 2013, the Company restructured one loan by granting concessions to borrowers experiencing financial difficulties. A residential loan was modified by changing payments to interest-only in order to reduce the monthly payment for a period of time.

During the three months ended June 30, 2012, the Company restructured one loan by granting concessions to a borrower experiencing financial difficulties. An owner-occupied commercial real estate loan was modified by changing the amortization period to reduce the payment amount. During the six months ended June 30, 2012, the Company restructured two loans by granting concessions to borrowers experiencing financial difficulties. One residential loan was modified by granting an interest rate reduction. In addition, one owner-occupied commercial real estate loan was modified by changing the amortization period to reduce the payment amount.

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

|                         | Three Months Ended<br>June 30, 2013<br>(in thousands) |                        |
|-------------------------|---|------------------------|
|                         | Number of<br>Contracts                                | Recorded<br>Investment |
| Commercial Real Estate: |   |                        |
| Owner occupied          | 1   | \$ 138                 |
| Non-owner occupied      | 1   | 557                    |
| Residential             |   |                        |
| Single family           | 4   | 954                    |
| Total                   | 6   | \$ 1,649               |

|               | Three Months Ended<br>June 30, 2012<br>(in thousands) |                        |
|---------------|---|------------------------|
|               | Number of<br>Contracts                                | Recorded<br>Investment |
| Residential   |   |                        |
| Single Family | 2   | \$555                  |
| Total         | 2   | \$555                  |

|                         | Six Months Ended<br>June 30, 2013<br>(in thousands) |                        |
|-------------------------|---|------------------------|
|                         | Number of<br>Contracts                              | Recorded<br>Investment |
| Commercial Real Estate: |   |                        |
| Owner occupied          | 2   | \$298                  |
| Non-owner occupied      | 1   | 557                    |
| Residential             |   |                        |
| Single family           | 4   | \$954                  |
| Total                   | 7   | \$ 1,809               |

|  | Six Months Ended<br>June 30, 2012<br>(in thousands) |                        |
|--|---|------------------------|
|  | Number of<br>Contracts                              | Recorded<br>Investment |



|               |   |       |
|---------------|---|-------|
| Residential   |   |       |
| Single family | 2 | \$555 |
| Total         | 2 | \$555 |

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

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## NOTE 7. Deposits

The composition of deposits at June 30, 2013 and December 31, 2012 was as follows:

|   | June 30, 2013  | December 31,<br>2012 |
|---|----------------|----------------------|
|   | (in thousands) |                      |
| Noninterest bearing demand deposits           | \$ 135,802     | \$ 134,871           |
| Savings and interest bearing demand deposits: |                |                      |
| NOW accounts                                  | \$ 87,450      | \$ 92,275            |
| Money market accounts                         | 88,301         | 85,021               |
| Regular savings accounts                      | 58,679         | 53,953               |
|   | \$ 234,430     | \$ 231,249           |
| Time deposits:                                |                |                      |
| Balances of less than \$100,000               | \$ 66,262      | \$ 68,780            |
| Balances of \$100,000 and more                | 36,818         | 42,201               |
|   | \$ 103,080     | \$ 110,981           |
|   | \$ 473,312     | \$ 477,101           |

## 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, except that the Company's unfunded cost that existed at January 1, 1993 is being accrued primarily in a straight-line manner that will result in its full accrual by December 31, 2013.

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

Net periodic benefit costs of the postretirement benefit plan were \$(1) thousand for the three months ended June 30, 2013 and 2012. Net periodic benefit costs of the postretirement benefit plan for the six months ended June 30, 2013 and 2012 were \$(2) thousand.

## 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. The principal asset of Trust II is \$7.2 million of the Company's junior subordinated debt securities with the same maturity and interest rate structures as the capital securities. The securities have a LIBOR-indexed floating rate of interest and the interest rate at June 30, 2013 was 1.89%. The securities have a mandatory redemption date of September 1, 2037, and were subject to varying call provisions beginning September 1, 2012.

The trust preferred securities are included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At June 30, 2013, the total amount (\$7.0 million) of trust preferred securities issued by Trust II is included in the Company's Tier 1 capital.

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

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

NOTE 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 June 30, 2013 and December 31, 2012:

|  | Balance as of     | Fair Value Measurements at |            |              |
|--|-------------------|----------------------------|------------|--------------|
|  |                   | June 30, 2013              | Using      | Significant  |
|  | June 30, 2013     | Quoted Prices              | Other      | Unobservable |
| (in thousands)   | (in thousands)    | in Active                  | Observable | Inputs       |
|  |                   | Markets for                | Inputs     | (Level 3)    |
|  |                   | Identical                  | (Level 2)  | (Level 3)    |
|  |                   | Assets                     | (Level 2)  | (Level 3)    |
|  |                   | (Level 1)                  | (Level 2)  | (Level 3)    |
| Assets:  |                   |                            |            |              |
| Securities available for sale                            |                   |                            |            |              |
| Obligations of U.S. government corporations and agencies | \$35,134          | \$—                        | \$35,134   | \$—          |
| Mortgage-backed securities                               | 18,298            | —                          | 18,298     | —            |
| Obligations of states and political subdivisions         | 42,456            | —                          | 42,456     | —            |
| Corporate securities                                     | 9,455             | —                          | 9,455      | —            |
| Equity securities:                                       |                   |                            |            |              |
| Bank preferred stock                                     | 1,160             | 1,160                      | —          | —            |
| Total assets at fair value                               | \$106,503         | \$1,160                    | \$105,343  | \$—          |
| Liabilities:   |                   |                            |            |              |
| Interest rate swap                                       | 471               | —                          | 471        | —            |
| Total liabilities at fair value                          | \$471             | \$—                        | \$471      | \$—          |
|  |                   |                            |            |              |
|  | Balance as of     | Fair Value Measurements at |            |              |
|  |                   | December 31, 2012          | Using      | Significant  |
|  | December 31, 2012 | Quoted Prices              | Other      | Unobservable |
| (in thousands)   | (in thousands)    | in Active                  | Observable | Inputs       |
|  |                   | Markets for                | Inputs     | (Level 3)    |
|  |                   | Identical                  | (Level 2)  | (Level 3)    |
|  |                   | Assets                     | (Level 2)  | (Level 3)    |
|  |                   | (Level 1)                  | (Level 2)  | (Level 3)    |
| Assets:  |                   |                            |            |              |
| Securities available for sale                            |                   |                            |            |              |
| Obligations of U.S. government corporations and agencies | \$23,692          | \$—                        | \$23,692   | \$—          |
| Mortgage-backed securities                               | 22,207            | —                          | 22,207     | —            |
| Obligations of states and political subdivisions         | 43,501            | —                          | 43,501     | —            |
| Corporate securities                                     | 11,156            | —                          | 11,156     | —            |
| Equity securities:                                       |                   |                            |            |              |
| Bank preferred stock                                     | 2,198             | 2,198                      | —          | —            |

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

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

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

**Impaired Loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. Level 2 impaired loan value is determined by utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Level 3 impaired loan values are determined using inventory and accounts receivables collateral and are based on financial statement balances or aging reports. If the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old or has been discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business, then the fair value is considered Level 3. Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

**Other Real Estate Owned:** Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lesser of the fair value of the property, less estimated selling costs or the loan balance outstanding at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell. Any subsequent valuation adjustments are applied to earnings in the consolidated statements of income. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of GAAP.

The following table displays quantitative information about Level 3 Fair Value Measurements for certain financial assets measured at fair value on a nonrecurring basis at June 30, 2013 (dollars in thousands):

| Quantitative information about Level 3 Fair Value Measurements for<br>June 30, 2013 |                       |       |                     |
|---|-----------------------|-------|---------------------|
| Valuation Technique(s)  | Unobservable<br>Input | Range | Weighted<br>Average |

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Assets:

|                         |                            |              |          |     |
|-------------------------|----------------------------|--------------|----------|-----|
| Impaired loans          | Discounted appraised value | Selling cost | 7% - 32% | 12% |
| Other real estate owned | Discounted appraised value | Selling cost | 6% - 12% | 7%  |



The following table summarizes the Company's financial and nonfinancial assets that were measured at fair value on a nonrecurring basis at June 30, 2013 and December 31, 2012:

|                         | Balance as of<br>June 30, 2013<br>(in thousands)        | Carrying value at<br>June 30, 2013  |   |  |
|-------------------------|---|---|---|--|
|                         |   | Identical<br>Assets<br>(Level 1)  | Observable<br>Inputs<br>(Level 2)                         | Unobservable<br>Inputs<br>(Level 3)                |
| Financial Assets:       |   |   |   |  |
| Impaired loans          | \$4,464   | \$—   | \$2,043   | \$2,421  |
| Nonfinancial Assets:    |   |   |   |  |
| Other real estate owned | 2,630   | —   | 2,630   | —  |
|                         | Balance as of<br>December 31,<br>2012<br>(in thousands) | Carrying value at<br>December 31, 2012  |   |  |
|                         |   | 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          | \$3,176   | \$—   | \$1,855   | \$1,321  |
| Nonfinancial Assets:    |   |   |   |  |
| Other real estate owned | 2,928   | —   | 2,320   | 608  |

The changes in Level 3 financial assets measured at estimated fair value on a nonrecurring basis during the period ended June 30, 2013 were as follows:

|                            | Fair Value Measurements at<br>June 30, 2013 |                            |
|----------------------------|---|----------------------------|
|                            | Impaired<br>Loans<br>(in thousands)         | Other Real<br>Estate Owned |
| Balance - January 1, 2013  | \$1,321                                     | \$608                      |
| Sales proceeds             | —   | —                          |
| Valuation allowance        | —   | —                          |
| (Loss) on disposition      | —   | —                          |
| Transfers into Level 3     | 1,976                                       | —                          |
| Transfers out of Level 3   | (876  | ) (608                     |
| Total assets at fair value | \$2,421                                     | \$—                        |

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

methods and assumptions were used to estimate the fair value of the Company's financial instruments:

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

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

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

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

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

The carrying value and fair value of the Company's financial instruments at June 30, 2013 and December 31, 2012 were as follows:

|  | Fair Value Measurements at<br>June 30, 2013<br>Using       |   |   |  | Fair Value as<br>of<br>June 30, 2013 |
|--|--|---|---|--|--------------------------------------|
|  | Carrying Value<br>as of<br>June 30, 2013<br>(in thousands) | 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) |                                      |
| <b>Financial Assets:</b>   |  |   |   |  |                                      |
| Cash and short-term investments  | \$10,632   | \$10,632  | \$—   | \$—  | \$10,632                             |
| Securities   | 106,503  | 1,160   | 105,343   | —  | 106,503                              |
| Restricted Investments   | 2,642  | —   | 2,642   | —  | 2,642                                |
| Loans, net   | 429,379  | —   | 434,215   | 2,421  | 436,636                              |
| Accrued interest receivable  | 1,864  | —   | 1,864   | —  | 1,864                                |
| <b>Financial Liabilities:</b>  |  |   |   |  |                                      |
| Deposits   | \$473,312  | \$—   | \$473,975   | \$—  | \$473,975                            |
| Federal funds purchased and<br>securities sold under agreements to<br>repurchase | 5,616  | —   | 5,616   | —  | 5,616                                |
| Federal Home Loan Bank advances  | 32,250   | —   | 32,876  | —  | 32,876                               |
| Trust preferred capital notes  | 7,217  | —   | 7,217   | —  | 7,217                                |
| Accrued interest payable   | 202  | —   | 202   | —  | 202                                  |
| Interest rate swap contract  | 471  | —   | 471   | —  | 471                                  |

Fair Value Measurements at  
December 31, 2012  
Using

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

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

#### NOTE 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 in Note 1. The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counterparty, the risk in these transactions is the cost of

replacing the agreements at current market rates.

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

The following table summarizes the fair value of derivative instruments at June 30, 2013 and December 31, 2012:

|  | June 30, 2013          |            | December 31, 2012      |            |
|--|------------------------|------------|------------------------|------------|
|  | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| (dollars in thousands)                                   |                        |            |                        |            |
| Derivatives designated as hedging instruments under GAAP |                        |            |                        |            |
| Interest rate swap contracts                             | Other Liabilities      | \$471      | Other Liabilities      | \$635      |

The following tables present the effect of the derivative instrument on the Consolidated Balance Sheet at June 30, 2013 and 2012 and the Consolidated Statements of Income for the three and six months ended June 30, 2013 and 2012:

| Derivatives in GAAP<br>Cash Flow Hedging<br>Relationships | Three Months Ended<br>June 30,                            |        |   | Amount of Gain<br>(Loss) |   | Location of Gain<br>(Loss)<br>Recognized in Income<br>(Ineffective Portion) | Amount of Gain<br>(Loss)<br>Recognized in Income<br>(Ineffective Portion) |  |
|---|---|--------|---|--------------------------|---|---|---|--|
|   | Recognized in OCI<br>on Derivative<br>(Effective Portion) |        | Recognized in Income<br>(Ineffective Portion) |                          | Recognized in Income<br>(Ineffective Portion) |   |   |  |
|   | 2013  | 2012   |   |                          | 2013  |   | 2012  |  |
|   | (dollars in thousands)                                    |        |   |                          | (dollars in thousands)                        |   |   |  |
| Interest rate swap contracts, net of tax                  | \$77  | \$(47) | ) Not applicable                              |                          | \$—   | \$—   |   |  |

| Derivatives in GAAP<br>Cash Flow Hedging<br>Relationships | Six Months Ended<br>June 30,                              |        |   | Amount of Gain<br>(Loss) |   | Location of Gain<br>(Loss)<br>Recognized in Income<br>(Ineffective Portion) | Amount of Gain<br>(Loss)<br>Recognized in Income<br>(Ineffective Portion) |  |
|---|---|--------|---|--------------------------|---|---|---|--|
|   | Recognized in OCI<br>on Derivative<br>(Effective Portion) |        | Recognized in Income<br>(Ineffective Portion) |                          | Recognized in Income<br>(Ineffective Portion) |   |   |  |
|   | 2013  | 2012   |   |                          | 2013  |   | 2012  |  |
|   | (dollars in thousands)                                    |        |   |                          | (dollars in thousands)                        |   |   |  |
| Interest rate swap contracts, net of tax                  | \$108   | \$(35) | ) Not applicable                              |                          | \$—   | \$—   |   |  |

#### 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 other comprehensive income are presented net of tax effect as a component of equity.

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

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



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|  |  | Three Months Ended<br>June 30,<br>2013                                      |   |  | 2012    |   |   |   |         |
|--|--|---|---|--|---------|---|---|---|---------|
|  |  | 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)  |   |  |         |   |   |   |         |
| March 31   |  | \$3,546   | \$(388)   | )\$43  | \$3,201 | \$3,433   | \$(370)   | )\$50   | \$3,113 |
| Other<br>comprehensive<br>(loss) income<br>before<br>reclassifications |  | (3,369)   | )117  | —  | (3,252) | )600  | (72)  | )—  | 528     |
| Reclassifications<br>from other<br>comprehensive<br>(loss) income      |  | (10)  | )—  | —  | (10)    | )14   | )—  | —   | (14)    |
| Tax effect of<br>current period<br>changes                             |  | 1,149   | (40)  | )—   | 1,109   | (200)   | )25   | —   | (175)   |
| Current period<br>changes net of<br>taxes                              |  | (2,230)   | )77   | —  | (2,153) | )386  | (47)  | )—  | 339     |
| June 30  |  | \$1,316   | \$(311)   | )\$43  | \$1,048 | \$3,819   | \$(417)   | )\$50   | \$3,452 |
|  |  | Six Months Ended<br>June 30,<br>2013  |   |  | 2012    |   |   |   |         |
|  |  | 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)  |   |  |         |   |   |   |         |
| December 31  |  | \$3,824   | \$(419)   | )\$43  | \$3,448 | \$3,263   | \$(382)   | )\$50   | \$2,931 |
| Other<br>comprehensive<br>income before<br>reclassifications           |  | (3,400)   | )164  | —  | (3,236) | )857  | (53)  | )—  | 804     |



|  |         |        |       |         |         |        |       |         |   |
|--|---------|--------|-------|---------|---------|--------|-------|---------|---|
| Reclassifications<br>from other<br>comprehensive<br>income | (400    | )—     | —     | (400    | )(14    | )—     | —     | (14     | ) |
| Tax effect of<br>current period<br>changes                 | 1,292   | (56    | )—    | 1,236   | (287    | )18    | —     | (269    | ) |
| Current period<br>changes net of<br>taxes                  | (2,508  | )108   | —     | (2,400  | )556    | (35    | )—    | 521     |   |
| June 30  | \$1,316 | \$(311 | )\$43 | \$1,048 | \$3,819 | \$(417 | )\$50 | \$3,452 |   |

For the three and six months ended June 30, 2013, \$10 thousand and \$400 thousand, respectively, was reclassified out of comprehensive income as realized gains on the sales of available for sale securities. For the three and six months ended June 30, 2012, \$14 thousand and \$14 thousand, respectively, was reclassified out of comprehensive income as realized gains on the sales of available for sale securities.

NOTE 13. Recent Accounting Pronouncements

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

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

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

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

NOTE 14. Subsequent Events

The Company has evaluated events and transactions subsequent to June 30, 2013 through the date these financial statements were issued. Based on definitions and requirements of Generally Accepted Accounting Principles for "Subsequent Events", the Company has not identified any events that would require adjustments to, or disclosure in the financial statements.

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 2012 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"), collectively (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 June 30, 2013, the Company had total assets of \$585.7 million, net loans of \$429.4 million, total deposits of \$473.3 million, and shareholders' equity of \$64.4 million. The Company's net income was \$3.8 million for the six months ended June 30, 2013.

MANAGEMENT'S STRATEGY

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

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

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

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

#### Commercial Real Estate Lending

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



### Construction and Land Development Lending

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

### Commercial and Industrial Lending

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

### Consumer Lending

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

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

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

#### CRITICAL ACCOUNTING POLICIES

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



The allowance for loan losses is an estimate of the losses that may be sustained in the Company's loan portfolio. As required by GAAP, the allowance for loan losses is accrued when their occurrence is probable and they can be estimated and that impairment losses be accrued based on the differences between the loan balance and the value of its collateral, the present value of future cash flows, or the price established in the secondary market. The Company's allowance for loan losses has three basic components: the general allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when actual events occur. The general allowance uses historical experience and other 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 classified as to how much loss would be realized on its disposition. The sum of the losses on the individual loans becomes the Company's specific allowance. This process is inherently subjective and actual losses may be greater than or less than the estimated specific allowance. The unallocated allowance captures losses that are attributable to various economic events which may affect a certain loan type within the loan portfolio or a certain industrial or geographic sector within the Company's market. As the loans, which are affected by these events, are identified or losses are experienced on the loans which are affected by these events, they will be reflected within the specific or formula allowances. Note 1 to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Data, of the 2012 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, 2012.

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 six months ended June 30, 2013 was \$3.8 million, an increase of \$88 thousand or 2.37% as compared to net income for the six months ended June 30, 2012 of \$3.7 million. Earnings per share, basic and diluted were \$1.13 and \$1.12 for the six months ended June 30, 2013 and 2012, respectively. Net income during the second quarter of 2013 and the second quarter of 2012 was \$2.0 million. Earnings per share, basic and diluted were \$0.59 and \$0.60 for the second quarter of 2013 and 2012, 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 six months ended June 30, 2013 and 2012 was 1.33%.

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 six months ended June 30, 2013 and 2012 was 11.91% and 12.52%, 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 \$11.2 million and \$11.8 million for the six months ended June 30, 2013 and 2012, respectively, which represents a decrease of \$593 thousand or 5.05%. Net interest income was \$5.6 million and \$5.9 million for the second quarter of 2013 and 2012, respectively, which represents a decrease of \$341 thousand or 5.76%. The amount of net interest income is derived from the volume of earning assets and the rates earned on those assets as compared to the cost of funds. Average interest earning assets increased \$10.7 million from the three months ended June 30, 2012 to the three months ended June 30, 2013 while the average yield decreased 47 basis points over that same period. Total interest income was \$12.5 million and \$13.5 million for the six months ended June 30, 2013 and 2012, respectively, which represents a decrease of \$1.0 million or 7.41%. Total interest income was \$6.2 million and \$6.8 million for the second quarter of 2013 and 2012, respectively, which represents a decrease of \$539 thousand or 7.97%. Total interest expense was \$1.3 million and \$1.8 million for the six months ended June 30, 2013 and 2012, respectively, which represents a decrease of \$407 thousand or 23.26%. Total interest expense was \$640 thousand and \$838 thousand for the second quarter of 2013 and 2012, respectively, which represents a decrease of \$198 thousand or 23.63%. Average interest bearing liabilities decreased \$10.9 million from the three months ended June 30, 2012 to the three months ended June 30, 2013 while the interest bearing liabilities rate decreased 18 basis points over the same period.

The net interest margin was 4.26% and 4.58% for the six months ended June 30, 2013 and 2012, respectively. The net interest margin was 4.28% and 4.60% for the second quarter of 2013 and 2012, 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 2013 and 2012. 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.

|   | Three Months Ended |         | Six Months Ended |          |
|---|--------------------|---------|------------------|----------|
|   | June 30,<br>2013   | 2012    | June 30,<br>2013 | 2012     |
|   | (in thousands)     |         | (in thousands)   |          |
| GAAP Financial Measurements:                                    |                    |         |                  |          |
| Interest Income - Loans   | \$5,343            | \$5,748 | \$10,674         | \$11,423 |
| Interest Income - Securities and Other Interest-Earnings Assets | 880                | 1,014   | 1,827            | 2,078    |
| Interest Expense - Deposits                                     | 288                | 397     | 614              | 841      |
| Interest Expense - Other Borrowings                             | 352                | 441     | 729              | 909      |
| Total Net Interest Income                                       | \$5,583            | \$5,924 | \$11,158         | \$11,751 |
| Non-GAAP Financial Measurements:                                |                    |         |                  |          |
| Add: Tax Benefit on Tax-Exempt Interest Income - Loans          | \$24               | \$26    | \$48             | \$53     |
| Add: Tax Benefit on Tax-Exempt Interest Income - Securities     | 162                | 181     | 329              | 366      |
| Total Tax Benefit on Tax-Exempt Interest Income                 | \$186              | \$207   | \$377            | \$419    |
| Tax-Equivalent Net Interest Income                              | \$5,769            | \$6,131 | \$11,535         | \$12,170 |

The tax-equivalent yield on earning assets decreased 48 basis points from 5.24% for the six months ended June 30, 2012 to 4.76% for the same period in 2013. During that same time, the tax-equivalent yield on securities decreased 47 basis points from 4.31% to 3.84%. The tax equivalent yield on loans decreased 41 basis points from 5.53% for the six months ended June 30, 2012 to 5.12% for the same time period in 2013. The average rate on interest bearing liabilities decreased 19 basis points from 0.91% for the six months ended June 30, 2012 to 0.72% for the same time period in 2013. The average rate on interest bearing deposits decreased 13 basis points from 0.50% to 0.37% 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, retail repurchase agreements and wholesale repurchase agreements. The average rate on these borrowings decreased three basis points from 3.50% to 3.47% for the six months ended June 30, 2012 and 2013, respectively. The cost of federal funds purchased is affected by the Federal Reserve's changes in the federal funds target rate which remained at 0.25% during the second quarter of 2013. The rate on wholesale repurchase agreements was fixed at 3.54%, but matured on January 30, 2013. The Company has not borrowed funds through retail repurchase agreements since June 2011. The Company also borrows from the FHLB in the form of short and long term advances. The average rate on FHLB advances decreased one basis point from 3.41% to 3.40% for the six months ended June 30, 2012 and 2013. There were no significant changes in asset mix during the six months ended June 30, 2013.

#### 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 any losses on existing loans that may become uncollectible. 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 \$767 thousand and \$600 thousand for the six months ended June 30, 2013 and 2012, respectively. The higher provision for loan losses is mainly reflective of the loan growth experienced during the second quarter of 2013.

Noninterest Income

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Total noninterest income for the six months ended June 30, 2013 and 2012 was \$4.4 million and \$3.0 million, respectively, which represents an increase of \$1.4 million or 44.63%. Total noninterest income for the second quarter of 2013 and 2012 was \$2.5 million and \$1.6 million, respectively, which represents an increase of \$896 thousand or 56.96%. 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 six months ended June 30, 2013 and 2012, which are included within the respective Consolidated Statements of Income headings.

| (dollars in thousands)              | Three Months Ended<br>June 30, |         |           |          | Six Months Ended<br>June 30, |         |           |          |   |
|-------------------------------------|--------------------------------|---------|-----------|----------|------------------------------|---------|-----------|----------|---|
|                                     | 2013                           | 2012    | \$ Change | % Change | 2013                         | 2012    | \$ Change | % Change |   |
| Income from fiduciary activities    | \$273                          | \$281   | \$(8)     | (3)      | \$633                        | \$521   | \$112     | 21       | % |
| Service changes on deposit accounts | 366                            | 370     | (4)       | (1)      | 709                          | 722     | (13)      | (2)      | % |
| Other service charges and fees      | 1,443                          | 868     | 575       | 66       | 2,243                        | 1,678   | 565       | 34       | % |
| Gain on sale of securities          | 10                             | 14      | (4)       | (29)     | 400                          | 14      | 386       | 2,757    | % |
| Other operating income              | 377                            | 40      | 337       | 843      | 416                          | 108     | 308       | 285      | % |
| Total noninterest income            | \$2,469                        | \$1,573 | \$896     | 57       | \$4,401                      | \$3,043 | \$1,358   | 45       | % |

Gain on sale of securities increased \$386 thousand or 2,757.14% from \$14 thousand to \$400 thousand for the six months ended June 30, 2012 and 2013, respectively. During the six months ended June 30, 2013, the Company sold \$2.8 million in available for sale securities. During the six months ended June 30, 2012, the Company sold \$1.6 million in available for sale securities.

Income from fiduciary activities, generated by trust services offered through Eagle Investment Group, increased \$112 thousand or 21.50% from \$521 thousand during the six months ended June 30, 2012 to \$633 thousand during the six months ended June 30, 2013. The amount of income from fiduciary activities is determined by the number of active accounts and total assets under management. Also, income can fluctuate due to the number of estates settled within any period. During the first quarter of 2013, the Company determined that it had under-accrued trust fees receivable during 2011 and 2012. An adjustment was made to increase the trust fees receivable account and increase the corresponding income from fiduciary activities. This adjustment accounts for the majority of the increase in income between the first quarter of 2012 and the first quarter of 2013.

Other service charges and fees increased \$565 thousand or 33.67% from \$1.7 million during the six months ended June 30, 2012 to \$2.2 million during the six months ended June 30, 2013. Other service charges and fees increased \$575 thousand or 66.24% from \$868 thousand during the three months ended June 30, 2012 to \$1.4 million during the three months ended June 30, 2013. 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. The majority of this increase is due to the sale of the merchant card portfolio which occurred in June 2013, resulting in gross proceeds of \$450 thousand.

Other operating income increased \$308 thousand or 285.19% from \$108 thousand to \$416 thousand during the six months ended June 30, 2012 and 2013, respectively. Other operating income increased \$337 thousand or 842.50% from \$40 thousand to \$377 thousand during the three months ended June 30, 2012 and 2013, respectively. This change resulted mostly from the receipt of life insurance benefits in the amount of \$254 thousand.

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

Noninterest Expenses

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Total noninterest expenses increased \$553 thousand or 6.16% from \$9.0 million to \$9.5 million for the six months ended June 30, 2012 and 2013. Total noninterest expenses increased \$572 thousand or 13.06% from \$4.4 million to \$5.0 million for the second quarter of 2012 and 2013, respectively. The efficiency ratio of the Company was 64.36% and 58.63% for the six months ended June 30, 2013 and 2012. The efficiency ratio is not a measurement under accounting principles generally accepted in the United States. It is calculated by dividing non interest expense by the sum of tax equivalent net interest income and non interest income excluding gains and losses on the investment portfolio. The tax rate utilized is 34%.

The following table presents the components of non-interest expense for the three and six months ended June 30, 2013 and 2012, which are included within the respective Consolidated Statements of Income headings.

| (dollars in thousands)                             | Three Months Ended<br>June 30, |         |           |          | Six Months Ended<br>June 30, |         |           |          |   |
|--|--------------------------------|---------|-----------|----------|------------------------------|---------|-----------|----------|---|
|  | 2013                           | 2012    | \$ Change | % Change | 2013                         | 2012    | \$ Change | % Change |   |
| Salaries and employee benefits                     | \$2,910                        | \$2,671 | \$239     | 9        | % \$5,551                    | \$5,284 | \$267     | 5        | % |
| Occupancy expenses                                 | 319                            | 287     | 32        | 11       | % 600                        | 579     | 21        | 4        | % |
| Equipment expenses                                 | 191                            | 176     | 15        | 9        | % 346                        | 340     | 6         | 2        | % |
| Advertising and marketing expenses                 | 144                            | 100     | 44        | 44       | % 271                        | 215     | 56        | 26       | % |
| Stationary and supplies                            | 68                             | 69      | (1)       | (1)      | % 146                        | 140     | 6         | 4        | % |
| ATM network fees                                   | 143                            | 135     | 8         | 6        | % 300                        | 257     | 43        | 17       | % |
| Other real estate owned expense                    | 20                             | 29      | (9)       | (31)     | % 28                         | 50      | (22)      | (44)     | % |
| (Gain) loss on the sale of other real estate owned | (53)                           | (4)     | (49)      | (1,225)  | % (53)                       | (15)    | (38)      | (253)    | % |
| FDIC assessment                                    | 96                             | (77)    | (173)     | (225)    | % 193                        | 106     | 87        | 82       | % |
| Computer software expense                          | 164                            | 101     | 63        | 62       | % 319                        | 236     | 83        | 35       | % |
| Bank franchise tax                                 | 101                            | 95      | 6         | 6        | % 202                        | 196     | 6         | 3        | % |
| Professional fees                                  | 284                            | 259     | 25        | 10       | % 525                        | 520     | 5         | 1        | % |
| Other operating expenses                           | 565                            | 539     | 26        | 5        | % 1,107                      | 1,074   | 33        | 3        | % |
| Total noninterest expenses                         | \$4,952                        | \$4,380 | \$572     | 13       | % \$9,535                    | \$8,982 | \$553     | 6        | % |

Advertising and marketing expenses increased \$56 thousand or 26.05% from \$215 thousand to \$271 thousand during the six months ended June 30, 2012 and 2013, respectively. Advertising and marketing expenses increased \$44 thousand or 44.00% from \$100 thousand to \$144 thousand during the three months ended June 30, 2012 and 2013.

This category contains numerous expense types such as advertising, public relations, business development and charitable contributions. The total amount of advertising and marketing expenses varies from quarter to quarter based on planned events and advertising campaigns. Expenses are allocated in a manner which focuses on effectively reaching the existing and potential customers within the market and contributing to the community. Advertising expenses were higher during the second quarter of 2013 due to the opening of the new Purcellville branch.

ATM network fees increased \$43 thousand or 16.73% from \$257 thousand to \$300 thousand during the six months ended June 30, 2012 and 2013, respectively. ATM network fees fluctuate based on the usage of ATM and debit cards.

Other real estate owned expense decreased \$22 thousand or 44.00% from \$50 thousand to \$28 thousand during the six months ended June 30, 2012 and 2013, respectively. Other real estate owned expense decreased \$9 thousand or 31.03% from \$29 thousand to \$20 thousand during the six months ended June 30, 2012 and 2013. During the first two quarters ended June 30, 2012, there were several properties requiring repairs in order to be in marketable condition,

leading to increased expenses.

Gain on the sale of other real estate owned increased \$38 thousand or 253.33% from \$15 thousand to \$53 thousand during the six months ended June 30, 2012 and 2013. Gain on the sale of other real estate owned increased \$49 thousand or 1,225.00% from \$4 thousand to \$53 thousand during the three months ended June 30, 2012 and 2013. During the second quarter of 2013, the Company sold two properties, with one property having a large gain of \$54 thousand. During the first and second quarters of 2012, the Company sold two and four properties, respectively. However, these properties had smaller gains and losses.

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FDIC assessments increased \$87 thousand or 82.08% from \$106 thousand to \$193 thousand during the six months ended June 30, 2012 and 2013, respectively. FIDC assessments increased \$173 thousand or 224.68% during the three months ended June 30, 2012 and 2013, respectively. During the second quarter of 2012, the Company determined that it had expensed too much of its remaining prepaid FDIC insurance balance during the period of October 1, 2011 through March 31, 2012. An adjustment was made to increase the prepaid balance and decrease the corresponding expense. This is the basis for the change in expense between 2013 and 2012. On December 30, 2009, the Company prepaid their estimated quarterly FDIC assessments of \$2.3 million for 2010, 2011, and 2012. The remaining prepaid FDIC balance of \$435 thousand was refunded to the Company on June 28, 2013.

Computer software expenses increased \$83 thousand or 35.17% from \$236 thousand to \$319 thousand during the six months ended June 30, 2012 and 2013, respectively. Computer software expenses increased \$63 thousand or 62.38% from \$101 thousand to \$164 thousand during the three months ended June 30, 2012 and 2013, respectively. As the Company grows and regulations increase, the Company has had to invest in additional software products causing expenses to increase.

#### Income Taxes

Income tax expense was \$1.5 million during the six months ended June 30, 2013 and 2012. These amounts correspond to an effective tax rate of 27.64% and 28.70% for the six months ended June 30, 2013 and 2012, 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.

### FINANCIAL CONDITION

#### Securities

Total securities were \$106.5 million at June 30, 2013, compared to \$102.8 million at December 31, 2012. This represents an increase of \$3.7 million or 3.65%. The Company purchased \$21.8 million in securities during the six months ended June 30, 2013. The Company had total maturities and principal repayments of \$11.8 million and total sales of \$2.8 million during the six months ended June 30, 2013. 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 June 30, 2013. Note 4 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio at June 30, 2013 and December 31, 2012. The Company had an unrealized gain on available for sale securities of \$2.0 million at June 30, 2013 as compared to an unrealized gain of \$5.8 million at December 31, 2012. Interest rates rose during the second quarter of 2013, causing corresponding declines in unrealized gains on the Company's investment portfolio. 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 \$436.4 million and \$418.1 million at June 30, 2013 and December 31, 2012, respectively. This represents an increase of \$18.3 million or 4.37% during the six months ended June 30, 2013. The ratio of loans to deposits increased during the six months ended June 30, 2013 from 87.63% at December 31, 2012 to 92.19% at June 30, 2013.

The loan portfolio consists primarily of loans for owner-occupied single family dwellings, loans to acquire consumer products such as automobiles, and loans to small farms and businesses. Note 5 to the Consolidated Financial Statements provides the composition of the loan portfolio at June 30, 2013 and December 31, 2012.

Loans secured by real estate were \$398.7 million or 91.36% and \$379.7 million or 90.81% of total loans at June 30, 2013 and December 31, 2012, respectively. This represents an increase of \$19.0 million or 5.00% during the six months ended June 30, 2013. Consumer installment loans were \$13.4 million or 3.08% and \$13.3 million or 3.18% of total loans at June 30, 2013 and December 31, 2012, respectively. This represents an increase of \$130 thousand or 0.98% during the six months ended June 30, 2013. Commercial and industrial loans were \$20.8 million or 4.77% and \$21.6 million or 5.18% of total loans at June 30, 2013 and December 31, 2012, respectively. This represents a decrease of \$818 thousand or 3.78% for the six months ended June 30, 2013.

### 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 six months ended June 30, 2013 and 2012 and the year ended December 31, 2012. Charged-off loans were \$446 thousand and \$846 thousand for the six months ended June 30, 2013 and 2012, respectively. Recoveries were \$80 thousand and \$131 thousand for the six months ended June 30, 2013 and 2012, respectively. This resulted in net charge-offs of \$366 thousand and \$715 thousand for the six months ended June 30, 2013 and 2012, respectively. The allowance for loan losses as a percentage of loans was 1.60% at June 30, 2013 and 1.57% at December 31, 2012. Management believes that the allowance for loan losses is currently adequate to absorb potential future losses inherent in the loan portfolio. The allowance for loan losses was 138.87% of nonperforming assets at June 30, 2013 and 123.12% of nonperforming assets at December 31, 2012. Given the current economic environment, it is anticipated there could be an increase in past due loans, non performing 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 and other real estate owned (foreclosed properties). Nonaccrual loans were \$2.4 million at June 30, 2013 and December 31, 2012. Other real estate owned and repossessed assets were \$2.6 million and \$2.9 million at June 30, 2013 and December 31, 2012. The Company held eight other real estate assets with an average balance of \$329 thousand at June 30, 2013. At December 31, 2012, the company held 10 other real estate assets with an average balance of \$293 thousand. The percentage of nonperforming assets to loans and other real estate owned was 1.14% at June 30, 2013 and 1.27% at December 31, 2012. Total loans past due 90 days or more and still accruing interest were \$201 thousand and \$208 thousand at June 30, 2013 and December 31, 2012, respectively.

During the six months ended June 30, 2013, the Bank placed six loans totaling \$476 thousand on nonaccrual status. 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 lower of the outstanding loan balance or 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 against the allowance for loan losses. A review of the recorded property value is performed in conjunction with normal loan reviews, and if market conditions indicate that the recorded value exceeds the fair market value, additional write downs of the property value are charged directly to operations.

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

circumstances and may include modifications to one or more loan provisions. Such restructured loans are included in impaired loans. However, restructured loans are not necessarily considered nonperforming assets. At June 30, 2013, the Company had \$8.1 million in restructured loans with specific allowances totaling \$515 thousand. At June 30, 2013, total restructured loans performing under the restructured terms and accruing interest were \$7.7 million. Three loans, totaling \$385 thousand, were in nonaccrual status at June 30, 2013.

#### Other Assets

Other assets increased \$8.5 million or 105.90% from \$8.1 million at December 31, 2012 to \$16.6 million at June 30, 2013. This increase was due mainly to a \$5.9 million receivable related to a participation sold loan. These funds were subsequently received in July 2013.

## Deposits

Total deposits were \$473.3 million and \$477.1 million at June 30, 2013 and December 31, 2012, respectively. This represents a decrease of \$3.8 million or 0.79% during the six months ended June 30, 2013. Note 7 to the Consolidated Financial Statements provides the composition of total deposits at June 30, 2013 and December 31, 2012.

Noninterest-bearing demand deposits which are comprised of checking accounts, increased \$931 thousand or 0.69% from \$134.9 million at December 31, 2012 to \$135.8 million at June 30, 2013. Savings and interest-bearing demand deposits, which include NOW accounts, money market accounts and regular savings accounts increased \$3.2 million or 1.38% from \$231.2 million at December 31, 2012 to \$234.4 million at June 30, 2013. Time deposits decreased \$7.9 million or 7.12% from \$111.0 million at December 31, 2012 to \$103.1 million at June 30, 2013. This is comprised of a decrease in time deposits of \$100,000 and more of \$5.4 million or 12.76% and a decrease in time deposits of less than \$100,000 of \$2.5 million or 3.66%. Certificates of deposit also included \$12.3 million and \$12.9 million in brokered certificates of deposit at June 30, 2013 and December 31, 2012, respectively.

## CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity at June 30, 2013 was \$64.4 million, reflecting a percentage of total assets of 11.00%, as compared to \$63.7 million and 10.74% at December 31, 2012. During the second quarter of 2012 and 2013, the Company paid a dividend of \$0.18 and \$0.19, respectively. Total dividends paid during 2012 were \$0.73 per share. The Company has a Dividend Investment Plan that reinvests the dividends of the shareholder in Company stock.

Federal regulatory risk-based capital guidelines require percentages to be applied to various assets, including off-balance sheet assets, based on their perceived risk in order to calculate risk-weighted assets. Tier 1 capital consists of total shareholders' equity plus qualifying trust preferred securities outstanding less net unrealized gains and losses on available for sale securities, goodwill and other intangible assets. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses and any excess trust preferred securities that do not qualify as Tier 1 capital. The \$7,000,000 in trust preferred securities, issued by the Company during 2007, qualifies as Tier 1 capital because this amount does not exceed 25% of total capital, including the trust preferred securities. For capital adequacy purposes, financial institutions must maintain a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a minimum Tier 1 leverage ratio of 4%. The Company's policy requires a Tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10% and a minimum Tier 1 leverage ratio of 5%. The Company's Tier 1 risk-based capital ratio was 16.50% at June 30, 2013 as compared to 16.73% at December 31, 2012. The Company's total risk-based capital ratio was 17.75% at June 30, 2013 as compared to 17.98% at December 31, 2012. The Company's Tier 1 capital to average total assets ratio was 12.29% at June 30, 2013 as compared to 11.70% at December 31, 2012. 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 June 30, 2013, liquid assets totaled \$197.6 million as compared to \$237.0 million at December 31, 2012. These amounts represent 37.91% and 44.74% of total liabilities at June 30, 2013 and December 31, 2012, respectively. The decrease in liquid assets was due to a decline in interest bearing deposits with other institutions. These liquid assets were

utilized to fund loan and securities growth during the first half of 2013. 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 2012 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 June 30, 2013 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

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

There were no changes in the Company's internal control over financial reporting during the Company's quarter ended June 30, 2013 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, 2012.

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 June 30, 2013 formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income (iv) Consolidated Statements of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) notes to Consolidated Financial Statements. |

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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 14th day of August, 2013.

Eagle Financial Services, Inc.

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

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

EXHIBIT INDEX

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