

EAGLE FINANCIAL SERVICES INC

Form 10-K

March 29, 2017

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

(Mark One)

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

For the fiscal year ended December 31, 2016

Commission File Number: 0-20146

EAGLE FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

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

2 East Main Street
P.O. Box 391 22611
Berryville, Virginia
(Address of principal executive offices) (Zip Code)
(540) 955-2510

(Registrant's telephone number, including area code)

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

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

Common Stock, Par Value \$2.50

(Title of class)

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

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

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

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

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

Large accelerated filer Accelerated filer

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

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

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The aggregate market value of the voting common equity held by non-affiliates of the registrant at June 30, 2016 was \$63,797,018.

The number of shares of the registrant's Common Stock (\$2.50 par value) outstanding as of March 17, 2017 was 3,477,210.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the 2017 Annual Meeting of Shareholders are incorporated by reference into Part III.

EAGLE FINANCIAL SERVICES, INC.
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PART I

Item 1. Business

General

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

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

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

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

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

Employees

The Company, including the Bank, had 58 officers, 105 other full-time and 26 part-time employees (or 171 full-time equivalent employees) at December 31, 2016. None of the Company’s employees are represented by a union or covered under a collective bargaining agreement. The Company considers relations with its employees to be excellent.

Securities and Exchange Commission Filings

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

Competition

There is significant competition for both loans and deposits within the Company's trade area. Competition for loans comes from other commercial banks, savings banks, credit unions, mortgage brokers, finance companies, insurance companies, and other institutional lenders. Competition for deposits comes from other commercial banks, savings banks, credit unions, brokerage firms, and other financial institutions. Based on total deposits at June 30, 2016 as reported to the FDIC, the Company has 6.7% of the total deposits in its market area. The Company's market area includes Clarke County, Frederick County, Loudoun County and the City of Winchester.

Supervision and Regulation

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

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

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

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

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

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

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

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

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

Payment of Dividends. The Company is a legal entity separate and distinct from the Bank. The majority of the Company's revenues are from dividends paid to the Company by the Bank. The Bank is subject to laws and regulations that limit the amount of dividends it can pay. In addition, both the Company and the Bank are subject to various regulatory restrictions relating to the payment of dividends, including requirements to maintain capital at or above regulatory minimums. Banking regulators have indicated that banking organizations should generally pay dividends only if the organization's current earnings are sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition. The Company does not expect that any of these laws, regulations or policies will materially affect the Bank's ability to pay dividends to the Company. Refer to Item 5 for additional information on dividend restrictions. During the year ended December 31, 2016, the Bank paid \$4.4 million in dividends to the Company. The Company paid cash dividends of \$2.4 million to shareholders during 2016.

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

Insurance of Accounts, Assessments and Regulation by the FDIC. The Bank's deposits are insured up to applicable limits by the FDIC. In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act permanently raised the standard maximum deposit insurance amount to \$250,000. The FDIC has implemented a risk-based assessment system in which assessment rates for insured institutions with under \$10 billion in assets are calculated based on supervisory evaluations and certain other financial measures. The assessment base is an institution's average consolidated total assets less average tangible equity, and the initial base assessment rates are currently between 3 and 30 basis points depending on the institutions risk category, and subject to potential adjustment based on certain long-term unsecured debt. Once the reserve ratio reaches 2.0% or greater, initial base assessment rates will range from 2 to 28 basis points and, once the reserve ratio reaches 2.5% or greater, the initial base assessment rate will range from 1 to 25 basis points.

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

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

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

Each of the federal bank regulatory agencies also has established a minimum leverage capital ratio of Tier 1 capital to average adjusted assets ("Tier 1 leverage ratio"). The guidelines require a minimum Tier 1 leverage ratio of 3.0% for financial holding companies and banking organizations with the highest supervisory rating. All other banking organizations were required to maintain a minimum Tier 1 leverage ratio of 4.0% unless a different minimum was specified by an appropriate regulatory authority (unchanged from the prior requirement). In addition, for a depository

institution to be considered “well capitalized” under the regulatory framework for prompt corrective action, its Tier 1 leverage ratio must be at least 5.0%. Banking organizations that have experienced internal growth or made acquisitions are expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. The Federal Reserve has not advised the Company or the Bank of any specific minimum leverage ratio applicable to either entity.

The capital requirements that became effective January 1, 2015 are the initial capital obligations, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7.0% upon full implementation); (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation); (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation); and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets. The capital conservation buffer requirement is being phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Future Legislation and Regulation. Congress may enact legislation from time to time that affects the regulation of the financial services industry, and state legislatures may enact legislation from time to time affecting the regulation of financial institutions chartered by or operating in those states. Federal and state regulatory agencies also periodically propose and adopt changes to their regulations or change the manner in which existing regulations are applied. The substance or impact of pending or future legislation or regulation, or the application thereof, cannot be predicted, although enactment of the proposed legislation could impact the regulatory structure under which the Company and the Bank operate and may significantly increase costs, impede the efficiency of internal business processes, require an increase in regulatory capital, require modifications to business strategy, and limit the ability to pursue business opportunities in an efficient manner. A change in statutes, regulations or regulatory policies applicable to the Company or the Bank could have a material, adverse effect on the business, financial condition and results of operations of the Company and the Bank. At this time, it is difficult to predict the legislative and regulatory changes that will result from the combination of a new President of the United States and the first year since 2010 in which both Houses of Congress and the White House have majority memberships from the same political party. In recent years, however, both the new President and senior members of the House of Representatives have advocated for significant reduction of financial services regulation, to include amendments to the Dodd-Frank Act and structural changes to the CFPB. The new administration and Congress also may cause broader economic changes due to changes in governing ideology and governing style. Future legislation, regulation, and government policy could affect the banking industry as a whole, including the business and results of operations of the Company and the Bank, in ways that are difficult to predict.

Item 1A. Risk Factors

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

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

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

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

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

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

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

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

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

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

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

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

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

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

At December 31, 2016, loans secured by real estate totaled \$471.8 million and represented 91.28% of the Company's loan portfolio. If we experience further adverse changes in the local real estate market or in the local or national economy, borrowers' ability to pay these loans may be further impaired, which could impact the Company's financial performance. The Company attempts to limit its exposure to this risk by applying good underwriting practices at origination, evaluating the appraisals used to establish property values, and routinely monitoring the financial condition of borrowers. If the value of real estate serving as collateral for the loan portfolio were to continue to decline materially, a significant part of the loan portfolio could become under-collateralized. If the loans that are secured by real estate become troubled when real estate market conditions are declining or have declined, in the event of foreclosure, the Company may not be able to realize the amount of collateral that was anticipated at the time of originating the loan. In that event, the Company might have to increase the provision for loan losses, which could have a material adverse effect on its operating results and financial condition.

An inadequate allowance for loan losses would reduce our earnings.

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

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

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

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

The Company's operations may be adversely affected by cyber security risks.

In the ordinary course of business, the Company collects and stores sensitive data, including proprietary business information and personally identifiable information of its customers and employees in systems and on networks. The secure processing, maintenance, and use of this information is critical to the Company's operations and business strategy. In addition, the Company relies heavily on communications and information systems to conduct its business. Any failure, interruption, or breach in security or operational integrity of these systems could result in failures or disruptions in the Company's customer relationship management, general ledger, deposit, loan, and other systems. The Company has invested in accepted technologies, and continually reviews processes and practices that are designed to protect its networks, computers, and data from damage or unauthorized access. Despite these security measures, the Company's computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance, or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged, or disclosed. A breach in security or other failure could result in legal claims, regulatory penalties, disruption in operations, increased expenses, loss of customers and business partners, and damage to the Company's reputation, which could adversely affect its business and financial condition. Furthermore, as cyber threats continue to evolve and increase, the Company may be required to expend significant additional financial and operational resources to modify or enhance its protective measures, or to investigate and remediate any identified information security vulnerabilities.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk

may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

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

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

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

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

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company owns or leases buildings which are used in normal business operations. The Company's corporate headquarters, and that of Bank of Clarke County, is located at 2 East Main Street, Berryville, Virginia, 22611. At December 31, 2016, Bank of Clarke County operated twelve full-service branches and one drive-through only facility in the Virginia communities of Berryville, Winchester, Boyce, Stephens City, Purcellville, Leesburg and Ashburn. See Note 1 "Nature of Banking Activities and Significant Accounting Policies" and Note 6 "Bank Premises and Equipment, Net" in the "Notes to the Consolidated Financial Statements" of this Form 10-K for information with respect to the amounts at which bank premises and equipment are carried and commitments under long-term leases.

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

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

None.

PART II

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

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

The Company has a limited record of trades involving its common stock in the sense of "bid" and "ask" prices or in highs and lows. The effort to accurately disclose trading prices is made more difficult due to the fact that price per share information is not required to be disclosed to the Company when shares of its stock have been sold by holders and purchased by others. The table titled "Common Stock Market Price and Dividend Data" summarizes the high and low sales prices of shares of the Company's common stock on the basis of trades known to the Company (including trades through the OTC Markets Group) and dividends declared during 2016 and 2015. The Company may not be aware of the per share price of all trades made.

Common Stock Market Price and Dividend Data

	2016		2015		Dividends Per Share	
	High	Low	High	Low	2016	2015
1st Quarter	\$24.00	\$22.85	\$24.50	\$22.85	\$0.20	\$0.20
2nd Quarter	23.74	22.25	26.25	23.10	0.20	0.20
3rd Quarter	23.99	22.70	24.80	22.90	0.20	0.20
4th Quarter	26.00	23.26	24.00	22.85	0.22	0.20

As of March 17, 2017, the Company had approximately 1,013 shareholders of record.

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

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

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

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

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

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

Issuer Purchases of Equity Securities for the Quarter Ended December 31, 2016

On June 15, 2016, the Corporation renewed the stock repurchase program to repurchase up to 150,000 shares of its common stock prior to June 30, 2017. During 2016, the Company purchased 89,607 shares of its Common Stock under its stock repurchase program at an average price of \$23.92.

The following table details the Company's purchases of its common stock during the fourth quarter pursuant to the Stock Repurchase program renewed on June 15, 2016. The Company authorized 150,000 shares for repurchase under the Stock Repurchase program. The program has an expiration date of June 30, 2017.

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares that may Yet Be Purchased Under the Plan
October 1 - October 31, 2016	8,090	\$ 23.70	8,090	72,806
November 1 - November 30, 2016	3,572	24.26	11,662	69,234
December 1 - December 31, 2016	8,841	24.51	20,503	60,393
	20,503	\$ 24.15	20,503	60,393

Stock Performance

The following line graph compares the cumulative total return to the shareholders of the Company to the returns of the NASDAQ Bank Index and the NASDAQ Composite Index for the last five years. The amounts in the table represent the value of the investment on December 31st of the year indicated, assuming \$100 was initially invested on December 31, 2011 and the reinvestment of dividends. See Management Discussion and Analysis sections Liquidity and Capital Resources and Note 17, "Restrictions on Dividends, Loans and Advances" to the Consolidated Financial Statements for information on Eagle Financial Services, Inc. ability and intent to pay dividends.

	2011	2012	2013	2014	2015	2016
Eagle Financial Services, Inc.	\$ 100	\$ 136	\$ 144	\$ 154	\$ 158	\$ 183
NASDAQ Bank Index	100	116	161	165	176	238
NASDAQ Composite Index	100	116	160	182	192	207

Item 6. Selected Financial Data

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

	December 31,					
	2016	2015	2014	2013	2012	
	(dollars in thousands, except per share amounts)					
Income Statement Data:						
Interest and dividend income	\$25,785	\$24,493	\$24,850	\$25,036	\$26,566	
Interest expense	1,067	1,347	1,912	2,585	3,384	
Net interest income	\$24,718	\$23,146	\$22,938	\$22,451	\$23,182	
(Recovery of) provision for loan losses	(188)	(227)	350	—	1,660	
Net interest income after (recovery of) provision for loan losses	\$24,906	\$23,373	\$22,588	\$22,451	\$21,552	
Noninterest income	6,669	8,438	6,606	7,462	6,127	
Net revenue	\$31,575	\$31,811	\$29,194	\$29,913	\$27,649	
Noninterest expenses	22,652	22,481	19,986	20,367	18,540	
Income before income taxes	\$8,923	\$9,330	\$9,208	\$9,546	\$9,109	
Income tax expense	2,553	2,433	2,068	2,388	2,559	
Net Income	\$6,370	\$6,897	\$7,140	\$7,158	\$6,550	
Performance Ratios:						
Return on average assets	0.96	% 1.10	% 1.19	% 1.23	% 1.15	%
Return on average equity	7.98	% 9.00	% 10.25	% 11.04	% 10.71	%
Shareholders' equity to assets	11.34	% 11.97	% 11.67	% 11.32	% 10.74	%
Dividend payout ratio	45.30	% 40.61	% 37.03	% 36.02	% 37.10	%
Non-performing loans to total loans	1.35	% 1.13	% 2.28	% 1.00	% 0.63	%
Non-performing assets to total assets	1.05	% 0.95	% 2.04	% 1.04	% 0.94	%
Per Common Share Data:						
Net income, basic	\$1.81	\$1.97	\$2.08	\$2.11	\$1.97	
Net income, diluted	1.81	1.97	2.08	2.11	1.96	
Cash dividends declared	0.82	0.80	0.77	0.76	0.73	
Book value	23.01	22.25	21.01	19.57	19.11	
Market price	25.75	23.00	23.30	22.50	22.00	
Average shares outstanding, basic	3,518,848	3,495,334	3,438,348	3,386,467	3,333,235	
Average shares outstanding, diluted	3,518,848	3,495,334	3,438,646	3,387,212	3,343,212	
Balance Sheet Data:						
Total securities	\$120,330	\$107,719	\$96,973	\$104,790	\$105,531	
Total loans	516,942	495,573	469,820	444,273	418,097	
Total assets	700,149	653,272	630,158	586,444	593,276	
Total deposits	603,877	550,718	503,816	487,587	477,101	
Shareholders' equity	79,416	78,221	73,132	66,406	63,706	

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

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

GENERAL

The Company is a bank holding company which owns 100% of the stock of Bank of Clarke County (the "Bank"). Accordingly, the results of operations for the Company are dependent upon the operations of the Bank. The Bank conducts commercial banking business which consists of attracting deposits from the general public and investing those funds in commercial, consumer and real estate loans and corporate, municipal and U.S. government agency securities. The Bank's deposits are insured by the Federal Deposit Insurance Corporation to the extent permitted by law. At December 31, 2016, the Company had total assets of \$700.1 million, net loans of \$512.4 million, total deposits of \$603.9 million and shareholders' equity of \$79.4 million. The Company's net income was \$6.4 million for the year ended December 31, 2016.

MANAGEMENT'S STRATEGY

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

OPERATING STRATEGY

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

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

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

LENDING POLICIES

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

debt.

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

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

One-to-Four-Family Residential Real Estate Lending

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

Commercial Real Estate Lending

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

Construction and Land Development Lending

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

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

Commercial and Industrial Lending

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

Consumer Lending

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

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

CRITICAL ACCOUNTING POLICIES

The financial statements of the Company are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial information contained within these statements is, to a significant extent, based on measurements of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. 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.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the probable losses inherent in the Company's loan portfolio. As required by GAAP, the allowance for loan losses is accrued when their occurrence is probable and they can be estimated. Impairment losses are accrued based on the differences between the loan balance and the value of its collateral, the present value of future cash flows, or the price established in the secondary market. The Company's allowance for loan losses has three basic components: the general allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when actual events occur. The general allowance uses historical experience and other qualitative factors to estimate future losses and, as a result, the estimated amount of losses can differ significantly from the actual amount of losses which would be incurred in the future. However, the potential for significant differences is mitigated by continuously updating the loss history of the Company. The specific allowance is based upon the evaluation of specific impaired loans on which a loss may be realized. Factors such as past due history, ability to pay, and collateral value are used to identify those loans on which a loss may be realized. Each of these loans is then evaluated to determine how much loss is estimated to be realized on its disposition. The sum of the losses on the individual loans becomes the Company's specific allowance. This process is inherently subjective and actual losses may be greater than or less than the estimated specific allowance. The unallocated allowance captures losses that are attributable to various economic events which may affect a certain loan type within the loan portfolio or a certain industrial or geographic sector within the Company's market. As the loans, which are affected by these events, are identified or losses are experienced on the loans which are affected by these events, they will be reflected within the specific or general allowances. Note 1 to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Data, of the 2016 Form 10-K, provides additional information related to the allowance for loan losses.

Other Real Estate Owned (OREO)

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of similar properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Company may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further deterioration in market conditions.

Other-Than-Temporary Impairment (OTTI) for Securities

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) we intend to sell the security or (ii) it is more-likely-than-not that we will be required to sell the security before recovery of its amortized cost basis. If, however, we do not intend to sell the security and it is not more-likely-than-not that we will be required to sell the security before recovery, we must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss). We regularly review each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, our best estimate of the present value of cash flows expected to be collected from debt securities, our intention with regard to holding the security to maturity and the likelihood that we would be required to sell the security before recovery.

FORWARD LOOKING STATEMENTS

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

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

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

RESULTS OF OPERATIONS

Net Income

Net income for 2016 was \$6.4 million, a decrease of \$527 thousand or 7.64% from 2015's net income of \$6.9 million. Net income for 2015 decreased \$243 thousand or 3.40% from 2014's net income of \$7.1 million. Basic and diluted earnings per share were \$1.81, \$1.97, and \$2.08 for 2016, 2015, and 2014, respectively.

Return on average assets (ROA) measures how efficiently the Company uses its assets to produce net income. Some issues reflected within this efficiency include the Company's asset mix, funding sources, pricing, fee generation, and cost control. The ROA of the Company, on an annualized basis, was 0.96%, 1.11%, and 1.19% for 2016, 2015, and 2014, respectively.

Return on average equity (ROE) measures the utilization of shareholders' equity in generating net income. This measurement is affected by the same factors as ROA with consideration to how much of the Company's assets are funded by the shareholders. The ROE for the Company was 7.98%, 9.17%, and 10.25% for 2016, 2015, and 2014, respectively.

Net Interest Income

Net interest income, the difference between total interest income and total interest expense, is the Company's primary source of earnings. Net interest income was \$24.7 million for 2016, \$23.1 million for 2015, and \$22.9 million for 2014, which represents an increase of \$1.6 million or 6.79% and \$208 thousand or 0.91% for 2016 and 2015, respectively. Net interest income is derived from the volume of earning assets and the rates earned on those assets as compared to the cost of funds. Total interest income was \$25.8 million for 2016, \$24.5 million for 2015, and \$24.9 million for 2014, which represents an increase of \$1.3 million or 5.27% and a decrease of \$357 thousand or 1.44% for 2016 and 2015, respectively. Total interest expense was \$1.1 million for 2016, \$1.3 million for 2015, and \$1.9 million for 2014, which represents a decrease of \$280 thousand or 20.79% and \$565 thousand or 29.55% in 2016 and 2015, respectively. The increase in total interest income during 2016 is driven mainly by the volume in interest-earning assets. The decrease in total interest expense during 2016 is driven mainly by the volume in interest-bearing liabilities, but also by the interest rate environment. Refer to the table titled "Volume and Rate Analysis" for further detail. The table titled "Average Balances, Income and Expenses, Yields and Rates" displays the composition of interest earnings assets and interest bearing liabilities and their respective yields and rates for the years ended December 31, 2016, 2015, and 2014.

The net interest margin was 4.07% for 2016, 4.06% for 2015, and 4.20% for 2014. The net interest margin is calculated by dividing tax-equivalent net interest income by total average earnings assets. Tax-equivalent net interest income is calculated by adding the tax benefit on certain securities and loans, whose interest is tax-exempt, to total interest income then subtracting total interest expense. The tax rate used to calculate the tax benefit was 34% for 2016, 2015, and 2014. The table titled "Tax-Equivalent Net Interest Income" reconciles net interest income to tax-equivalent net interest income, which is not a measurement under GAAP, for the years ended December 31, 2016, 2015, and 2014.

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. More decline is likely occur in the net interest margin than in the cost of funds due to the low level of interest rates currently being paid on interest bearing liabilities.

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Average Balances, Income and Expenses, Yields and Rates

(dollars in thousands)

	December 31, 2016			December 31, 2015			December 31, 2014		
	Average Balances	Interest Income/ Expense	Average Yield/ Rate	Average Balances	Interest Income/ Expense	Average Yield/ Rate	Average Balances	Interest Income/ Expense	Average Yield/ Rate
Assets:									
Securities:									
Taxable	\$72,824	\$1,750	2.40 %	\$71,159	\$1,744	2.45 %	\$68,119	\$2,047	3.01 %
Tax-Exempt (1)	32,495	1,401	4.31 %	31,592	1,472	4.66 %	33,652	1,661	4.94 %
Total Securities	\$105,319	\$3,151	2.99 %	\$102,751	\$3,216	3.13 %	\$101,771	\$3,708	3.64 %
Loans:									
Taxable	497,720	22,815	4.58 %	465,444	21,523	4.62 %	449,247	21,477	4.78 %
Non-accrual	5,891	—	— %	6,446	—	— %	6,811	—	— %
Tax-Exempt (1)	6,423	336	5.23 %	7,210	346	4.80 %	5,789	330	5.70 %
Total Loans	\$510,034	\$23,151	4.54 %	\$479,100	\$21,869	4.56 %	\$461,847	\$21,807	4.72 %
Federal funds sold	36	—	— %	—	—	— %	—	—	— %
Interest-bearing deposits in other banks	15,179	73	0.48 %	12,174	26	0.21 %	6,075	12	0.20 %
Total earning assets (2)	\$624,677	\$26,375	4.22 %	\$587,579	\$25,111	4.27 %	\$562,882	\$25,527	4.54 %
Allowance for loan losses	(4,967)			(5,374)			(5,839)		
Total non-earning assets	44,440			47,626			43,008		
Total assets	\$664,150			\$629,831			\$600,051		
Liabilities and Shareholders' Equity:									
Equity:									
Interest-bearing deposits:									
NOW accounts	\$81,966	\$93	0.11 %	\$80,809	\$85	0.11 %	\$82,821	\$88	0.11 %
Money market accounts	117,210	201	0.17 %	99,088	113	0.11 %	94,650	108	0.11 %
Savings accounts	87,035	51	0.06 %	76,054	41	0.05 %	67,515	35	0.05 %
Time deposits:									
\$100,000 and more	44,193	255	0.58 %	36,098	170	0.47 %	35,341	181	0.51 %
Less than \$100,000	45,133	187	0.41 %	57,992	332	0.57 %	61,136	512	0.84 %
Total interest-bearing deposits	\$375,537	\$787	0.21 %	\$350,041	\$741	0.21 %	\$341,463	\$924	0.27 %
Federal funds purchased and securities sold under agreements to repurchase	73	1	1.37 %	1,154	10	0.87 %	1,865	20	1.07 %
Federal Home Loan Bank advances	10,546	136	1.29 %	24,849	336	1.35 %	28,818	650	2.26 %
Trust preferred capital notes (3)	—	—	— %	4,441	196	4.41 %	7,217	318	4.41 %
Total interest-bearing liabilities	\$386,156	\$924	0.24 %	\$380,485	\$1,283	0.34 %	\$379,363	\$1,912	0.50 %
Noninterest-bearing liabilities:									
Demand deposits	195,428			171,508			149,026		
Other Liabilities	2,752			2,599			1,981		
Total liabilities	\$584,336			\$554,592			\$530,370		

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Shareholders' equity	79,814	75,239	69,681
Total liabilities and shareholders' equity	\$664,150	\$629,831	\$600,051
Net interest income	\$25,451	\$23,828	\$23,615
Net interest spread	3.98 %	3.93 %	4.04 %
Interest expense as a percent of average earning assets	0.15 %	0.22 %	0.34 %
Net interest margin	4.07 %	4.06 %	4.20 %

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

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

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

Tax-Equivalent Net Interest Income
(dollars in thousands)

	December 31,		
	2016	2015	2014
GAAP Financial Measurements:			
Interest Income - Loans	\$23,037	\$21,751	\$21,695
Interest Income - Securities and Other Interest-Earnings Assets	2,748	2,742	3,155
Interest Expense - Deposits	787	741	924
Interest Expense - Interest Rate Swap	143	182	186
Interest Expense - Other Borrowings	137	424	802
Total Net Interest Income	\$24,718	\$23,146	\$22,938
Non-GAAP Financial Measurements:			
Add: Tax Benefit on Tax-Exempt Interest Income - Loans (1)	\$114	\$118	\$112
Add: Tax Benefit on Tax-Exempt Interest Income - Securities (1)	476	500	565
Total Tax Benefit on Tax-Exempt Interest Income	\$590	\$618	\$677
Add: Interest Expense - Interest Rate Swap (2)	143	64	—
Tax-Equivalent Net Interest Income	\$25,451	\$23,828	\$23,615

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

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

The tax-equivalent yield on earning assets decreased five basis points from 2015 to 2016 and 27 basis points from 2014 to 2015. The tax-equivalent yield on securities decreased 14 basis points from 2015 to 2016 and 51 basis points from 2014 to 2015. The tax-equivalent yield on loans decreased two basis points from 2015 to 2016 and 16 basis points from 2014 to 2015. The decrease in the yield on earning assets, securities, and the loan portfolio was primarily a result of the low interest rate environment that extended through 2016.

The average rate on interest-bearing liabilities decreased 10 basis points from 2015 to 2016 and 16 basis points from 2014 to 2015. These changes were caused primarily by the prepayment of the FHLB advance during 2016 and the redemption of the trust preferred debt during the third quarter of 2015. An intentional shift in the product mix, to move from time deposits to non-maturity deposits during 2015 was planned and achieved. The average rate on total interest-bearing deposits remained steady from 2015 to 2016 and decreased six basis points from 2014 to 2015. In general, deposit pricing is done in response to monetary policy actions and yield curve changes. Local competition for funds affects the cost of time deposits, which are primarily comprised of certificates of deposit. The Company issues brokered certificates of deposit as a substitute for offering promotional certificates of deposit when their rates are lower. The rates on brokered certificates of deposit are usually comparable with other wholesale funding sources and these funds can be gathered more efficiently without causing existing deposits to reprice. The Company prefers to rely most heavily on non-maturity deposits, which include NOW accounts, money market accounts, and savings accounts. The average balance of non-maturity interest-bearing deposits increased \$30.3 million or 11.83% from \$256.0 million during 2015 to \$286.2 million in 2016 and \$11.0 million or 4.48% from \$245.0 million at December 31, 2014 during 2015. Changes in the average rate on interest-bearing liabilities can also be affected by the pricing on other sources of funds, namely borrowings. The Company from time to time will utilize overnight borrowings in the form of federal funds purchased. The average rate on these borrowings increased 50 basis points from 2015 to 2016 and decreased 20 basis points from 2014 to 2015. The cost of federal funds purchased is affected by the Federal Reserve's changes in the federal funds target rate, which increased to 0.75% during 2016, from 0.50% in 2015. Finally, the Company borrows from the Federal Home Loan Bank through short and long term advances. The average rate on FHLB advances decreased six basis points from 2015 to 2016 and 91 basis points from 2014 to 2015. The average balance on FHLB advances decreased \$14.3 million during 2016 and decreased \$4.0 million during 2015.

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

The table titled “Volume and Rate Analysis” provides information about the effect of changes in financial assets and liabilities and changes in rates on net interest income. Non-accruing loans are excluded from the average outstanding loans. Tax-equivalent net interest income increased \$1.6 million during 2016. The increase in tax-equivalent net interest income during 2016 is comprised of an increase due to volume of \$1.8 million and a decrease due to rate of \$191 thousand. The increase in tax-equivalent net interest income during 2016 was primarily affected by the increased volume of taxable loans, partially offset by a decline in the rate earned on taxable loans, and the decreased cost of Federal Home Loan Bank advances.

Volume and Rate Analysis (Tax-Equivalent Basis)
(dollars in thousands)

	2016 vs 2015			2015 vs 2014		
	Increase (Decrease)			Increase (Decrease)		
	Due to Changes in:			Due to Changes in:		
	Volume	Rate	Total	Volume	Rate	Total
Earning Assets:						
Securities:						
Taxable	\$47	\$(41)	\$6	\$96	\$(399)	\$(303)
Tax-exempt	44	(115)	(71)	(98)	(91)	(189)
Loans:						
Taxable	1,476	(184)	1,292	643	(597)	46
Tax-exempt	(56)	46	(10)	45	(29)	16
Federal funds sold	—	—	—	—	—	—
Interest-bearing deposits in other banks	8	39	47	13	1	14
Total earning assets	\$1,519	\$(255)	\$1,264	\$699	\$(1,115)	\$(416)
Interest-Bearing Liabilities:						
NOW accounts	\$8	\$—	\$8	\$(3)	\$—	\$(3)
Money market accounts	22	66	88	5	—	5
Savings accounts	4	6	10	6	—	6
Time deposits:						
\$100,000 and more	42	43	85	4	(15)	(11)
Less than \$100,000	(64)	(81)	(145)	(25)	(155)	(180)
Total interest-bearing deposits	\$12	\$34	\$46	\$(13)	\$(170)	\$(183)
Federal funds purchased and securities sold under agreements to repurchase	\$(23)	\$14	\$(9)	\$(7)	\$(3)	\$(10)
Federal Home Loan Bank advances	(186)	(14)	(200)	(80)	(234)	(314)
Trust preferred capital notes	(98)	(98)	(196)	(122)	—	(122)
Total interest-bearing liabilities	\$(295)	\$(64)	\$(359)	\$(222)	\$(407)	\$(629)
Change in net interest income	\$1,814	\$(191)	\$1,623	\$921	\$(708)	\$213

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 (recovery of) provision for loan losses was \$(188) thousand for 2016, \$(227) thousand for 2015, and \$350 thousand for 2014. Changes in the amount of provision for loan losses during each period reflect the results of the Bank’s analysis used to determine the adequacy of the allowance for loan losses. The recovery of loan losses in 2015 and 2016, compared to a provision for loan losses in 2014, reflects lower specific reserves on remaining impaired loans as well as a decline in the historical loss experience utilized in our allowance model. The Company is committed to maintaining an allowance that adequately reflects the risk inherent in the loan portfolio. This commitment is more fully discussed in the “Asset Quality” section.

Noninterest Income

Total noninterest income was \$6.7 million, \$8.4 million, and \$6.6 million during 2016, 2015, and 2014, respectively. This represents a decrease of \$1.8 million or 20.96% for 2016 and an increase of \$1,832 thousand or 27.73% for 2015. Management reviews the activities which generate noninterest income on an ongoing basis.

The following table provides the components of noninterest income for the twelve months ended December 31, 2016, 2015, and 2014, which are included within the respective Consolidated Statements of Income headings. The following paragraphs provide information about activities which are included within the respective Consolidated Statements of Income headings. Variances that the Company believes require explanation are discussed below the table.

(dollars in thousands)	December 31,		\$ Change	% Change	December 31,		\$ Change	% Change
	2016	2015			2015	2014		
Income from fiduciary activities	\$1,356	\$1,338	\$18	1.35	% \$1,338	\$1,162	\$176	15.15 %
Service charges on deposit accounts	1,227	1,244	(17)	(1.37)	% 1,244	1,323	(79)	(5.97) %
Other service charges and fees	3,713	3,375	338	10.01	% 3,375	2,995	380	12.69 %
(Loss) on the sale and disposal of premises and equipment	(10)	(76)	66	NM	(76)	(14)	(62)	NM
Gain on sale of securities	98	124	(26)	NM	124	990	(866)	NM
Gain on redemption of trust preferred debt	—	2,424	(2,424)	NM	2,424	—	2,424	NM
Other operating income	285	9	276	3,066.67	% 9	150	(141)	(94.00) %
Total noninterest income	\$6,669	\$8,438	\$(1,769)	(20.96)	% \$8,438	\$6,606	\$1,832	27.73 %
NM - Not Meaningful								

Income from fiduciary activities, generated by trust services offered through Eagle Investment Group, increased by \$176 thousand or 15.15% for 2015. The amount of income from fiduciary activities is determined by the number of active accounts and total assets under management. Also, income can fluctuate due to the number of estates settled within any period. During the first quarter of 2015, the Company collected and recognized into income approximately \$100 thousand of prior year trust fees from one client, causing an increase in income from fiduciary activities. These particular fees were not accrued during prior years due to questions of collectability from the client. In future periods, trust fees for this client will be accrued and billed on a quarterly basis.

The amount of other services charges and fees is comprised primarily of commissions from the sale of non-deposit investment products, fees received from the Bank's credit card program, fees generated from the Bank's ATM/debit card programs, and fees generated from procuring applications for secondary market loans. Other service charges and fees increased by \$338 thousand or 10.01% for 2016. This increase can be attributed to an increase of ATM fee income of \$172 thousand for 2016. Other service charges and fees increased by \$380 thousand or 12.69% for 2015. This increase can be attributed to increased activity in non-deposit investment products and an increase of ATM fee income of \$155 thousand for 2015.

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

Other operating income increased \$276 thousand during 2016 and decreased \$141 thousand or 94.00% during 2015. During the third quarter of 2015, the Company's cash flow hedge was derecognized upon the retirement of the trust preferred capital note as discussed in the previous paragraph. As a result, the loss on the interest rate swap derivative contract recorded in accumulated other comprehensive income of \$237 thousand was reclassified to the income statement during the third quarter of 2015, which was partially offset by the adjustment of the derivative contract to

fair value for a gain of \$88 thousand. A fair value adjustment (gain) to the derivative contract of \$149 thousand was recognized through other operating income during 2016.

Noninterest Expenses

Total noninterest expenses were \$22.7 million, \$22.5 million, and \$20.0 million during 2016, 2015, and 2014, respectively. This represents an increase of \$171 thousand or 0.76% during 2016 and an increase of \$2.5 million or 12.48% during 2015. The efficiency ratio of the Company was 70.71%, 75.77%, and 67.59% for 2016, 2015, and 2014, respectively. The efficiency ratio is calculated by dividing total noninterest expenses by the sum of tax-equivalent net interest income and total noninterest income, excluding certain non-recurring gains and losses. A reconciliation of tax-equivalent net interest income, which is not a measurement under GAAP, to net interest income is presented within the Net Interest Income section above.

The following table provides the components of noninterest expense for the twelve months ended December 31, 2016, 2015, and 2014, which are included within the respective Consolidated Statements of Income headings. The following paragraphs provide information about activities which are included within the respective Consolidated Statements of Income headings. Variances that the Company believes require explanation are discussed below the table.

(dollars in thousands)	December 31,		\$	%	2015	2014	\$	%	Change	% Change
	2016	2015								
Salaries and employee benefits	\$13,015	\$12,318	\$ 697	5.66	% \$12,318	\$11,427	\$891	7.80		%
Occupancy expenses	1,486	1,563	(77)	(4.93)	% 1,563	1,280	283	22.11		%
Equipment expenses	1,333	1,102	231	20.96	% 1,102	720	382	53.06		%
Advertising and marketing expenses	633	612	21	3.43	% 612	571	41	7.18		%
Stationery and supplies	201	242	(41)	(16.94)	% 242	307	(65)	(21.17)		%
ATM network fees	903	805	98	12.17	% 805	712	93	13.06		%
Other real estate owned expense	73	336	(263)	(78.27)	% 336	27	309	1,144.44		%
Loss (gain) on foreclosure and sale of other real estate owned	90	(46))136	NM	(46)	(82))36	NM		
FDIC assessment	304	439	(135)	(30.75)	% 439	357	82	22.97		%
Computer software expense	623	696	(73)	(10.49)	% 696	872	(176)	(20.18)		%
Bank franchise tax	501	505	(4)	(0.79)	% 505	466	39	8.37		%
Professional fees	949	1,025	(76)	(7.41)	% 1,025	988	37	3.74		%
Other bank services charges	209	71	138	194.37	% 71	73	(2)	(2.74)		%
Cost to terminate operating lease	—	520	(520)	NM	520	—	520	NM		
Other operating expenses	2,332	2,293	39	1.70	% 2,293	2,268	25	1.10		%
Total noninterest expenses	\$22,652	\$22,481	\$ 171	0.76	% \$22,481	\$19,986	\$2,495	12.48		%

NM - Not Meaningful

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

Occupancy expense decreased during 2016 despite expected increases from branching efforts in 2014 and 2015. This decrease can largely be attributed to decreased rental expense related to the closing of the branch Round Hill, Virginia and the purchase of the land that the Millbrook branch is located on.

Stationery and supplies expense decreased during 2016 and 2015 due to efforts to promote paperless statements to customers as well as internal efforts to maintain paperless records where possible.

ATM network fees increased 12.17% during 2016 and 13.06% during 2015. ATM network fees fluctuate based on the usage of ATM and debit cards. This expense has increased similarly to increases in deposit accounts.

Other real estate owned expenses decreased during 2016 and increased during 2015. This fluctuation is due mainly to a valuation adjustment of \$288 thousand that was recorded during 2015. No valuation allowances were established during 2016 and 2014.

FDIC assessments decreased \$135 thousand or 30.75% during 2016 and increased \$82 thousand or 22.97% during 2015. As of July 1, 2016 new FDIC assessment changes became effective. The changes included a new lower assessment rate schedule and small institution pricing changes, which caused the subsequent assessments to decrease by approximately 50%. During 2015 there were increases in the total assessment base as well as the quarterly multiplier, which caused the overall expense to increase.

Computer software expense decreased during 2016 and 2015, despite the increase in number of branches and employees. Fees paid to our core software provider have decreased due to a conscious effort to reduce unused services and renegotiate contract amounts.

Other bank service charges increased during 2016. The Company elected to prepay a \$20.0 million outstanding advance with the Federal Home Loan Bank of Atlanta. A \$136 thousand prepayment fee was incurred by the Company in July 2016 in conjunction with the repayment of the advance.

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

Income Taxes

Income tax expense was \$2.6 million, \$2.4 million, and \$2.1 million for the years ended December 31, 2016, 2015, and 2014, respectively. The change in income tax expense can be attributed to changes in taxable earnings at the federal statutory income tax rate of 34%. These amounts correspond to an effective tax rate of 28.62%, 26.08%, and 22.46% for 2016, 2015, and 2014, respectively. The effective tax rate increased from 2015 when compared to 2016 due to a refund received during 2016 related to an amended 2014 tax return. The refund was related to a loss from an investment that the Company was not aware of until the K-1 was provided to us. Note 9 to the Consolidated Financial Statements provides a reconciliation between income tax expense computed using the federal statutory income tax rate and the Company's actual income tax expense during 2016, 2015, and 2014.

FINANCIAL CONDITION

Assets, Liabilities and Shareholders' Equity

The Company's total assets were \$700.1 million at December 31, 2016, an increase of \$46.88 million or 7.18% from \$653.3 million at December 31, 2015. Securities increased \$13.44 million or 12.70% from 2015 to 2016. Loans, net of allowance for loan losses, increased by \$21.8 million or 4.45% from 2015 to 2016. Total liabilities were \$620.7 million at December 31, 2016, compared to \$575.1 million at December 31, 2015. Total shareholders' equity at year end 2016 and 2015 was \$79.4 million and \$78.2 million, respectively.

Securities

Total securities, excluding restricted stock at December 31, 2016 were \$119.3 million as compared to \$105.8 million as of December 31, 2015, which represents an increase of \$13.44 million or 12.70% during 2016. The table titled "Securities Portfolio" shows the carrying value of securities at December 31, 2016, 2015, and 2014. The Company purchased \$40.4 million in securities during 2016. This amount includes \$3.6 million or 8.83% in obligations of U.S. government corporations and agencies, \$22.5 million or 55.74% in mortgage-backed securities and \$14.3 million or 35.42% in obligations of states and political subdivisions. The Company had \$23.5 million in maturities, calls, and principal repayments on securities during 2016. This amount includes \$11.54 million or 49.18% in obligations of U.S. government corporations and agencies, \$5.70 million or 24.31% in mortgage-backed securities and \$6.22 million or 26.51% in obligations of states and political subdivisions. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity as of December 31, 2016. Note 2 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio as of December 31, 2016 and 2015.

Securities Portfolio
(dollars in thousands)

	December 31,		
	2016	2015	2014
Securities available for sale:			
Obligations of U.S. government corporations and agencies	\$30,441	\$37,665	\$37,211
Mortgage-backed securities	42,372	28,931	15,779
Obligations of states and political subdivisions	46,449	39,227	40,410
Corporate securities	—	—	765
	\$119,262	\$105,823	\$94,165

The ability to dispose of available for sale securities prior to maturity provides management more options to react to future rate changes and provides more liquidity, when needed, to meet short-term obligations. The Company had a net unrealized loss on available for sale securities of \$94 thousand and a net unrealized gain of \$1.5 million at December 31, 2016 and 2015, respectively. Unrealized gains or losses on available for sale securities are reported within shareholders' equity, net of the related deferred tax effect, as accumulated other comprehensive income (loss). The table titled "Maturity Distribution and Yields of Securities" shows the maturity period and average yield for the different types of securities in the portfolio at December 31, 2016. Although mortgage-backed securities have definitive maturities, they provide monthly principal curtailments which can be reinvested at a prevailing rate and for a different term.

Maturity Distribution and Yields of Securities
(dollars in thousands)

	December 31, 2016									
	Due in one year or less		Due after 1 through 5 years		Due after 5 through 10 years		Due after 10 years and Equity Securities		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available for sale:										
Obligations of U.S. government corporations and agencies	\$1,012	2.52%	\$9,119	2.58%	\$18,369	2.25%	\$1,941	2.61%	\$30,441	2.38%
Mortgage-backed securities	—	—%	—	—%	1,314	2.90%	41,058	2.31%	42,372	2.33%
Obligations of states and political subdivisions, taxable	386	1.15%	4,573	3.85%	4,601	2.89%	1,229	2.17%	10,789	3.14%
Total taxable	\$1,398	2.14%	\$13,692	3.00%	\$24,284	2.41%	\$44,228	2.32%	\$83,602	2.45%
Obligations of states and political subdivisions, tax-exempt (1)	2,029	3.14%	9,289	2.95%	19,433	2.56%	4,909	2.93%	35,660	2.74%
Total	\$3,427	2.73%	\$22,981	2.98%	\$43,717	2.47%	\$49,137	2.38%	\$119,262	2.54%

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

Loan Portfolio

The Company's primary use of funds is supporting lending activities from which it derives the greatest amount of interest income. Gross loans were \$516.9 million and \$495.6 million at December 31, 2016 and 2015, respectively. This represents an increase of \$21.37 million or 4.31% for 2016. The ratio of net loans to deposits decreased during the year from 89.09% to 84.86% at December 31, 2015 and December 31, 2016, respectively. The table titled "Loan Portfolio" shows the composition of the loan portfolio over the last five years.

Loan Portfolio

(dollars in thousands)

	December 31,				
	2016	2015	2014	2013	2012
Loans secured by real estate:					
Construction and land development	\$23,266	\$35,019	\$25,887	\$27,047	\$30,846
Secured by farmland	8,525	6,550	10,602	9,886	7,030
Secured by 1-4 family residential properties	227,966	229,651	224,694	218,633	214,619
Multifamily	3,566	3,975	3,016	2,850	2,808
Commercial	208,525	175,172	161,299	148,166	124,382
Loans to farmers	1,338	1,331	957	1,321	1,525
Commercial and industrial loans	30,341	29,366	28,132	20,865	21,640
Consumer installment loans	12,677	13,530	13,874	13,785	13,307
All other loans	738	979	1,359	1,720	1,940
Total loans	\$516,942	\$495,573	\$469,820	\$444,273	\$418,097

Loans secured by real estate were \$471.8 million or 91.28% and \$450.4 million or 90.88% of total loans at December 31, 2016 and 2015, respectively. This represents an increase of \$21.48 million or 4.77% for 2016. Consumer installment loans were \$12.7 million or 2.45% and \$13.5 million or 2.73% of total loans at December 31, 2016 and 2015, respectively. This represents a decrease of \$853 thousand or 6.30% for 2016. Commercial and industrial loans were \$30.3 million or 5.87% and \$29.4 million or 5.93% of total loans at December 31, 2016 and 2015. This represents an increase of \$975 thousand or 3.32% for 2016.

The table titled "Maturity Schedule of Selected Loans" shows the different loan categories and the period during which they mature. For loans maturing in more than one year, the table also shows a breakdown between fixed rate loans and floating rate loans. The table indicates that \$322.4 million or 62.36% of the loan portfolio matures within five years. The floating rate loans maturing after five years are primarily comprised of home equity lines of credit.

Maturity Schedule of Selected Loans

(dollars in thousands)

	December 31, 2016			
	Within 1 Year	After 1 Year Within 5 Years	After 5 Years	Total
Loans secured by real estate:				
Construction and land development	\$13,319	\$5,722	\$4,225	\$23,266
Secured by farmland	4,784	2,668	1,073	8,525
Secured by 1-4 family residential properties	36,772	93,707	97,487	227,966
Multifamily	465	1,424	1,677	3,566
Commercial	21,492	103,236	83,797	208,525
Loans to farmers	460	638	240	1,338
Commercial and industrial loans	15,242	9,520	5,579	30,341
Consumer installment loans	1,054	11,222	401	12,677
All other loans	—	659	79	738
	\$93,588	\$228,796	\$194,558	\$516,942
For maturities over one year:				
Floating rate loans		\$7,874	\$56,688	\$64,562
Fixed rate loans		220,922	137,870	358,792
		\$228,796	\$194,558	\$423,354

Asset Quality

The Company has policies and procedures designed to control credit risk and to maintain the quality of its loan portfolio. These include underwriting standards for new originations and ongoing monitoring and reporting of asset quality and adequacy of the allowance for loan losses. There were \$7.4 million in total non-performing assets, which consist of nonaccrual loans, other real estate owned, and repossessed assets at December 31, 2016. This is an increase of \$1.5 million when compared to the December 31, 2015 balance of \$5.9 million. This increase resulted mostly from the increase in nonaccrual loans as discussed below.

Nonaccrual loans were \$7.0 million at December 31, 2016 and \$5.3 million at 2015. The gross amount of interest income that would have been recognized on nonaccrual loans was \$147 thousand for 2016 and \$63 thousand for 2015. None of this interest income was included in net income for 2016 or 2015. A total of 14 loans totaling \$5.1 million were placed in nonaccrual during 2016. The additions to nonaccrual loans during the year included a \$4.1 million loan that is secured by two large, multi-acre residential properties located in Loudoun County, VA. In addition, 15 loans totaling \$3.1 million were removed from nonaccrual status during 2016. Of the \$3.1 million in loans removed from nonaccrual status between December 31, 2015 and December 31, 2016, 8 loans totaling \$1.9 million were returned to accruing status, 5 loans totaling \$584 thousand were paid off and 2 loans totaling \$639 thousand were written off. Management evaluates the financial condition of these borrowers and the value of any collateral on these loans. The results of these evaluations are used to estimate the amount of losses which may be realized on the disposition of these nonaccrual loans. Nonaccrual loans that were evaluated for impairment at December 31, 2016 totaled \$7.0 million and had \$105 thousand in specific allocations.

Other real estate owned decreased to \$370 thousand at December 31, 2016, compared to \$571 thousand at December 31, 2015. Four foreclosed properties were sold during 2016, while three foreclosed properties were acquired. When the property is sold, the difference between the amount of other real estate owned and the settlement proceeds is recognized as a gain or loss on the sale of other real estate owned. A net loss of \$90 thousand and a net gain of \$46 thousand was recognized on the foreclosure and sale of other real estate owned during 2016 and 2015, respectively. A net gain of \$82 thousand was recognized on the sale of other real estate owned during 2014.

Total loans past due 90 days or more and still accruing interest were \$8 thousand or less than one basis point, \$307 thousand or 0.06%, and \$6 thousand or less than one basis point of total loans at December 31, 2016, 2015, and 2014, respectively. The loans past due 90 days or more and still accruing interest are well secured and in the process of collection; therefore, they were not classified as nonaccrual.

Nonperforming and Other Assets

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

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

For real estate loans, upon foreclosure, the properties are recorded at the fair value of the property based on current appraisals and other current market trends, less selling costs. If a write down of the OREO property is necessary at the time of foreclosure, the amount is charged-off against the allowance for loan losses. A review of the recorded property value is performed in conjunction with normal loan reviews, and if market conditions indicate that the recorded value exceeds the fair value, additional write downs of the property value are charged directly to operations. Gains on properties acquired through foreclosure where the fair value less costs to sell exceeds the related loan balance and there have been no prior charge-offs are recorded to current earnings.

In addition, the Company may, under certain circumstances, restructure loans in troubled debt restructurings as a concession to a borrower when the borrower is experiencing financial distress. Formal, standardized loan restructuring programs are not utilized by the Company. Each loan considered for restructuring is evaluated based on customer circumstances and may include modifications to one or more loan provisions. Such restructured loans are included in impaired loans. At December 31, 2016, 2015, 2014, 2013, and 2012, the Company had \$7.3 million, \$7.5 million, \$7.8 million, \$6.4 million, and \$8.2 million in restructured loans, respectively.

Nonperforming Assets
(dollars in thousands)

	December 31,					
	2016	2015	2014	2013	2012	
Nonaccrual loans	\$6,991	\$5,285	\$10,706	\$4,412	\$2,414	
Other real estate owned and repossessed assets	375	571	2,109	1,646	2,934	
Total nonperforming assets	\$7,366	\$5,856	\$12,815	\$6,058	\$5,348	
Loans past due 90 days and accruing interest	\$8	\$307	\$6	\$11	\$208	
Allowance for loan losses to nonperforming assets	61	% 85	% 40	% 91	% 123	%
Non-performing assets to period end loans and other real estate owned	1.42	% 1.18	% 2.72	% 1.36	% 1.27	%

Other potential problem loans are defined as performing loans that possess certain risks that management has identified that could result in the loans not being repaid in accordance with their terms. Accordingly, these loans are risk rated at a level of substandard or lower. At December 31, 2016, other potential problem loans totaled \$6.4 million. Of the total other potential problem loans, \$6.4 million or 100.00% are currently considered impaired and are disclosed in Note 4 to the Consolidated Financial Statements.

Allowance for Loan Losses

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

Charged-off loans were \$607 thousand, \$456 thousand, and \$1.5 million for 2016, 2015, and 2014, respectively. Recoveries were \$341 thousand, \$562 thousand, and \$725 thousand for 2016, 2015, and 2014, respectively. Net charge-offs were \$266 thousand and \$758 thousand for 2016 and 2014, respectively. Net recoveries were \$106 thousand for 2015. This represents an increase in net charge-offs of \$372 thousand or 350.94% for 2016 and a decrease of \$864 thousand or 113.98% for 2015. The allowance for loan losses as a percentage of loans was 0.87%, 1.00%, and 1.08% at the end of 2016, 2015, and 2014, respectively. The decreases in allowance for loan losses as a percentage of total loans from December 31, 2015 to December 31, 2016 is primarily due to a decline in the historical loss experience utilized in our allowance model. In addition, the Company was diligent in maintaining updated appraisals for collateral-dependent impaired loans, which resulted in an overall decrease in specific reserves in the allowance for loan losses during 2016. The allowance for loan losses at year-end covered net charge-offs during the year by 16.94 times for 2016 and 6.70 times for 2014. This ratio for 2015 is not considered meaningful due to net recoveries being recognized during the year. The ratio of net charge-offs (recoveries) to average loans was 0.05% for 2016, (0.02)% for 2015, and 0.16% for 2014.

The (recovery of) provision for loan losses for the year ended December 31, 2016 was \$(188) thousand, compared to \$(227) thousand and \$350 thousand for the years ended December 31, 2015 and 2014, respectively. The recovery of loan losses reflects reductions in impaired loans as well as non-performing assets combined with a net recovery position for 2015 and minimal net charge-offs for 2016.

The table titled "Allocation of Allowance for Loan Losses" shows the amount of the allowance for loan losses which is allocated to the indicated loan categories, along with that category's percentage of total loans, at December 31, 2016, 2015, 2014, 2013, and 2012. The amount of allowance for loan losses allocated to each loan category is based on the amount delinquent loans in that loan category, the status of nonperforming assets in that loan category, the historical losses for that loan category, and the financial condition of certain borrowers whose financial condition is monitored on a periodic basis. Management believes that the allowance for loan losses is adequate based on the loan portfolio's current risk characteristics.

Analysis of Allowance for Loan Losses
(dollars in thousands)

	December 31,					
	2016	2015	2014	2013	2012	
Balance, beginning of period	\$4,959	\$5,080	\$5,488	\$6,577	\$8,743	
Loans charged-off:						
Commercial, financial and agricultural	—	—	—	403	207	
Real estate-construction and land development	—	166	482	20	1,313	
Real estate-mortgage	535	199	891	796	2,499	
Consumer	72	91	110	103	144	
Total loans charged off	\$607	\$456	\$1,483	\$1,322	\$4,163	
Recoveries:						
Commercial, financial and agricultural	\$11	\$181	\$164	\$47	\$36	
Real estate-construction and land development	144	75	26	5	4	
Real estate-mortgage	132	257	444	116	213	
Consumer	54	49	91	65	84	
Total recoveries	\$341	\$562	\$725	\$233	\$337	
Net charge-offs (recoveries)	266	(106)	758	1,089	3,826	
(Recovery of) provision for loan losses	(188)	(227)	350	—	1,660	
Balance, end of period	\$4,505	\$4,959	\$5,080	\$5,488	\$6,577	
Ratio of allowance for loan losses to loans outstanding at period end	0.87	% 1.00	% 1.08	% 1.24	% 1.57	%
Ratio of net charge offs to average loans outstanding during the period	0.05	% (0.02)	% 0.16	% 0.25	% 0.91	%

Allocation of Allowance for Loan Losses
(dollars in thousands)

	Commercial, Financial, and Agricultural			Real Estate Construction			Real Estate Mortgage			Consumer and Other Loans		
	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	%	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	%	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	%	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	%
December 31, 2016	\$ 235	5.9	%	\$450	6.1	%	\$3,514	85.1	%	\$91	2.9	%
December 31, 2015	211	5.9	%	775	8.4	%	3,590	82.5	%	162	3.2	%
December 31, 2014	464	6.0	%	951	7.8	%	3,324	82.8	%	145	3.4	%
December 31, 2013	555	4.7	%	1,032	8.3	%	3,562	83.2	%	184	3.8	%
December 31, 2012	880	5.2	%	1,280	9.0	%	4,002	81.8	%	229	4.0	%

Deposits

Total deposits were \$603.9 million and \$550.7 million at December 31, 2016 and 2015, respectively, which represents an increase of \$53.2 million or 9.65% during 2016. The table titled "Average Deposits and Rates Paid" shows the average deposit balances and average rates paid for 2016, 2015 and 2014.

Average Deposits and Rates Paid

(dollars in thousands)

	December 31,		2015		2014	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing	\$195,428		\$171,508		\$149,026	
Interest-bearing:						
NOW accounts	81,966	0.11 %	80,809	0.11 %	82,821	0.11 %
Money market accounts	117,210	0.17 %	99,088	0.11 %	94,650	0.11 %
Regular savings accounts	87,035	0.06 %	76,054	0.05 %	67,515	0.05 %
Time deposits:						
\$100,000 and more	44,193	0.58 %	36,098	0.47 %	35,341	0.51 %
Less than \$100,000	45,133	0.41 %	57,992	0.57 %	61,136	0.84 %
Total interest-bearing	\$375,537	0.21 %	\$350,041	0.21 %	\$341,463	0.27 %
Total deposits	\$570,965		\$521,549		\$490,489	

Noninterest-bearing demand deposits, which are comprised of checking accounts, increased \$22.8 million or 12.26% from \$186.1 million at December 31, 2015 to \$208.9 million at December 31, 2016. Interest-bearing deposits, which include NOW accounts, money market accounts, regular savings accounts and time deposits, increased \$30.3 million or 8.32% from \$364.6 million at December 31, 2015 to \$394.9 million at December 31, 2016. Total money market account balances increased \$21.07 million or 19.96% from \$105.6 million at December 31, 2015 to \$126.6 million at December 31, 2016. Total regular savings account balances increased \$13.8 million or 17.17% from \$80.5 million at December 31, 2015 to \$94.3 million at December 31, 2016. Time deposits decreased \$4.3 million or 4.64% from \$92.4 million at December 31, 2015 to \$88.1 million at December 31, 2016. Pricing decisions made by management and influenced by the low interest rate environment resulted in the decline in certificate of deposits. Brokered certificates of deposits decreased \$10.73 million from \$12.94 million at December 31, 2015 to \$2.2 million at December 31, 2016. The \$11.0 million of traditional brokered certificates of deposit outstanding at December 31, 2015 were called during 2016. The brokered certificates balance at December 31, 2016 consists of certificates obtained through the CDARS network. The Bank joined the CDARS network in 2008, which allows it to offer over \$50 million in FDIC insurance on a certificate of deposit.

The Company attempts to fund asset growth with deposit accounts and focus upon core deposit growth as its primary source of funding. Core deposits consist of checking accounts, NOW accounts, money market accounts, regular savings accounts, and time deposits of less than \$250,000, including brokered certificates of deposit. Core deposits totaled \$580.7 million or 96.17% and \$525.8 million or 95.48% of total deposits at December 31, 2016 and 2015, respectively.

The table titled "Maturities of Certificates of Deposit and Other Time Deposits of \$100,000 and Greater" shows the amount of certificates of deposit of \$100,000 and more maturing within the time period indicated at December 31, 2016. The total amount maturing within one year is \$37.7 million or 81.34% of the total amount outstanding.

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

	Within Three Months	Three to Six Months	Six to Twelve Months	Over One Year	Total	Percent of Total Deposits
December 31, 2016	\$15,631	\$9,037	\$13,061	\$8,654	\$46,383	7.68 %

CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity on December 31, 2016 was \$79.4 million, reflecting a percentage of total assets of 11.34% as compared to \$78.2 million and 11.97% at December 31, 2015. The common stock's book value per share increased \$0.76 or 3.42% to \$23.01 per share at December 31, 2016 from \$22.25 per share at December 31, 2015. During 2016, the Company paid \$0.82 per share in dividends as compared to \$0.80 per share for 2015 and \$0.77 per share for 2014. The Company has a Dividend Investment Plan that allows participating shareholders to reinvest the dividends in Company stock. During 2016, the Company purchased 89,607 shares of its Common Stock under its stock repurchase program at an average price of \$23.92. All of these shares were retired. There was no repurchase activity during 2015 and 2014.

Analysis of Consolidated Capital
(dollars in thousands)

	December 31, 2016	December 31, 2015		
Tier 1 Capital:				
Common stock	\$8,633	\$8,758		
Capital surplus	12,642	13,730		
Retained earnings	58,165	54,682		
Total Tier 1 capital	\$79,440	\$77,170		
Common equity Tier 1 capital	\$79,440	\$77,170		
Tier 2 Capital:				
Allowance for loan losses	\$4,537	\$4,986		
Total Tier 2 capital	\$4,537	\$4,986		
Total risk-based capital	\$83,977	\$82,156		
Risk weighted assets	\$506,632	\$507,090		
Risk Based Capital Ratios:				
Common equity Tier 1 capital ratio	15.68	%	15.22	%
Tier 1 risk-based capital ratio	15.68	%	15.22	%
Total risk-based capital ratio	16.58	%	16.20	%
Tier 1 leverage ratio	11.84	%	12.13	%

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

In July 2013, the Federal Reserve issued final rules to include technical changes to its market risk capital rules to align them with the Basel III regulatory capital framework and meet certain requirements of the Dodd-Frank Act. Effective January 1, 2015, the final rules require the Company and the Bank to comply with the following minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6.0% of risk-weighted assets (increased from the prior requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4.0% of total assets (unchanged from the prior requirement). These are the initial capital requirements, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets. The capital conservation buffer requirement will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall. The table titled "Analysis of Capital" shows the components of Tier 1 capital, Tier 2 capital, the amount of total risk-based capital and risk-weighted assets, and the risk based capital ratios for the Company at December 31, 2016 and 2015. Beginning January 1, 2015, the Company calculates its regulatory capital under the U.S. Basel III Standardized Approach. The Company calculated regulatory capital measures for periods prior to 2015 under previous regulatory requirements.

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

LIQUIDITY

Liquidity management involves meeting the present and future financial obligations of the Company with the sale or maturity of assets or with the occurrence of additional liabilities. Liquidity needs are met with cash on hand, deposits in banks, federal funds sold, securities classified as available for sale and loans maturing within one year. At December 31, 2016 liquid assets totaled \$248.1 million as compared to \$227.9 million at December 31, 2015. These amounts represent 39.97% and 39.64% of total liabilities at December 31, 2016 and 2015, respectively. Securities provide a constant source of liquidity through paydowns and maturities. Also, the Company maintains short-term borrowing arrangements, namely federal funds lines of credit, with larger financial institutions as an additional source of liquidity. The Bank's membership with the Federal Home Loan Bank of Atlanta also provides a source of borrowings with numerous rate and term structures. The Company's senior management monitors the liquidity position regularly and attempts to maintain a position which utilizes available funds most efficiently. As a result of the Company's management of liquid assets and the ability to generate liquidity through liability funding, management

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

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OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

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

The table titled “Contractual Obligations and Scheduled Payments” presents the Company’s contractual obligations and scheduled payment amounts due within the period indicated at December 31, 2016.

Contractual Obligations and Scheduled Payments
(dollars in thousands)

	December 31, 2016				
	One Year	Three Years	More than		Total
	Less than	through	Five Years		
	One Year	Three			
	Years	Years			
Operating leases	\$ 200	\$ 400	\$ 433	\$ 1,944	\$ 2,977
	\$ 200	\$ 400	\$ 433	\$ 1,944	\$ 2,977

The payments due on operating leases are discussed in Note 6 to the Consolidated Financial Statements.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

As the holding company of the Bank, the Company's primary component of market risk is interest rate volatility. Interest rate fluctuations will impact the amount of interest income and expense the Bank receives or pays on almost all of its assets and liabilities and the market value of its interest-earning assets and interest-bearing liabilities, excluding those which have a very short term until maturity. Interest rate risk exposure of the Company is, therefore, experienced at the Bank level. Asset / liability management attempts to maximize the net interest income of the Company by adjusting the volume and price of rate sensitive assets and liabilities. The Company does not subject itself to foreign currency exchange or commodity price risk due to prohibition through policy and the current nature of operations. Note 14 to the Consolidated Financial Statements discusses derivative instruments and hedging activities of the Company. The Company entered into an interest rate swap agreement related to the outstanding trust preferred capital notes during 2008. The interest rate swap agreement expired on December 1, 2016.

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

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

Year 1 Net Interest Income Simulation
(dollars in thousands)

Assumed Market Interest Rate Shock	Change in Net Interest Income		
	Dollars	Percent	Change
-100 BP	\$(956)	(3.90))%
+100 BP	(204)	(0.80))%
+200 BP	(474)	(1.90))%
+300 BP	(645)	(2.60))%
+400 BP	(840)	(3.40))%

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

risk position over time.

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

Static EVE Change

(dollars in thousands)

Assumed Market Interest Rate Shift	Change in EVE		
	Dollars	Percent	Change
-100 BP Shock	\$(17,815)	(16.40)%
+100 BP Shock	5,638	5.20	%
+200 BP Shock	8,481	7.80	%
+300 BP Shock	10,968	10.10	%
+400 BP Shock	12,652	11.70	%

Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Eagle Financial Services, Inc. and Subsidiary as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Eagle Financial Services, Inc. and Subsidiary as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

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

Winchester, Virginia
March 29, 2017

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

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

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

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

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

Chambersburg, Pennsylvania
March 30, 2015

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 2016 and 2015

(dollars in thousands, except share amounts)

	2016	2015
Assets		
Cash and due from banks	\$12,515	\$11,082
Interest-bearing deposits with other institutions	22,610	12,139
Federal funds sold	156	—
Total cash and cash equivalents	35,281	23,221
Securities available for sale, at fair value	119,262	105,823
Restricted investments	1,068	1,896
Loans	516,942	495,573
Allowance for loan losses	(4,505)	(4,959)
Net loans	512,437	490,614
Bank premises and equipment, net	20,169	20,964
Other real estate owned, net of allowance	370	571
Other assets	11,562	10,183
Total assets	\$700,149	\$653,272
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest bearing demand deposits	\$208,948	\$186,133
Savings and interest bearing demand deposits	306,847	272,214
Time deposits	88,082	92,371
Total deposits	\$603,877	\$550,718
Federal Home Loan Bank advances	—	20,000
Other liabilities	16,856	4,333
Total liabilities	\$620,733	\$575,051
Commitments and contingencies		
Shareholders' Equity		
Preferred stock, \$10 par value; 500,000 shares authorized and unissued	\$—	\$—
Common stock, \$2.50 par value; authorized 10,000,000 shares; issued and outstanding 2016, 3,468,243 including 14,901 unvested restricted stock; issued and outstanding 2015, 3,517,648 including 14,401 unvested restricted stock	8,633	8,758
Surplus	12,642	13,730
Retained earnings	58,165	54,682
Accumulated other comprehensive (loss) income	(24)	1,051
Total shareholders' equity	\$79,416	\$78,221
Total liabilities and shareholders' equity	\$700,149	\$653,272
See Notes to Consolidated Financial Statements		

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

Consolidated Statements of Income

Years Ended December 31, 2016, 2015, and 2014

(dollars in thousands, except per share amounts)

	2016	2015	2014
Interest and Dividend Income			
Interest and fees on loans	\$23,037	\$21,751	\$21,695
Interest and dividends on securities available for sale:			
Taxable interest income	1,669	1,645	1,825
Interest income exempt from federal income taxes	925	972	1,096
Dividends	81	99	222
Interest on deposits in banks	73	26	12
Total interest and dividend income	\$25,785	\$24,493	\$24,850
Interest Expense			
Interest on deposits	787	741	924
Interest on federal funds purchased and securities sold under agreements to repurchase	1	10	20
Interest on Federal Home Loan Bank advances	136	336	650
Interest on trust preferred capital notes	—	78	132
Interest on interest rate swap	143	182	186
Total interest expense	\$1,067	\$1,347	\$1,912
Net interest income	\$24,718	\$23,146	\$22,938
(Recovery Of) Provision For Loan Losses	(188)	(227)	350
Net interest income after (recovery of) provision for loan losses	\$24,906	\$23,373	\$22,588
Noninterest Income			
Income from fiduciary activities	\$1,356	\$1,338	\$1,162
Service charges on deposit accounts	1,227	1,244	1,323
Other service charges and fees	3,713	3,375	2,995
(Loss) on the sale and disposal of premises and equipment	(10)	(76)	(14)
Gain on sale of securities	98	124	990
Gain on redemption of trust preferred debt	—	2,424	—
Other operating income	285	9	150
Total noninterest income	\$6,669	\$8,438	\$6,606
Noninterest Expenses			
Salaries and employee benefits	\$13,015	\$12,318	\$11,427
Occupancy expenses	1,486	1,563	1,280
Equipment expenses	1,333	1,102	720
Advertising and marketing expenses	633	612	571
Stationery and supplies	201	242	307
ATM network fees	903	805	712
Other real estate owned expense	73	336	27
Loss (gain) on foreclosure and sale of other real estate owned	90	(46)	(82)
FDIC assessment	304	439	357
Computer software expense	623	696	872
Bank franchise tax	501	505	466
Professional fees	949	1,025	988
Other bank service charges	209	71	73
Cost to terminate operating lease	—	520	—

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Other operating expenses	2,332	2,293	2,268
Total noninterest expenses	\$22,652	\$22,481	\$19,986
Income before income taxes	\$8,923	\$9,330	\$9,208
Income Tax Expense	2,553	2,433	2,068
Net income	\$6,370	\$6,897	\$7,140
Earnings Per Share			
Net income per common share, basic	\$1.81	\$1.97	\$2.08
Net income per common share, diluted	\$1.81	\$1.97	\$2.08
See Notes to Consolidated Financial Statements			

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EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2016, 2015, and 2014

(dollars in thousands)

	2016	2015	2014
Net income	\$6,370	\$6,897	\$7,140
Other comprehensive (loss) income:			
Changes in benefit obligations and plan assets for post retirement benefit plans, net of deferred income tax of \$0, \$0 and (\$3) for the years ended December 31, 2016, 2015, and 2014, respectively	—	—	(5)
Unrealized (loss) gain on available for sale securities, net of reclassification adjustments, net of deferred income tax of (\$554), (\$234), and \$473 for the years ended December 31, 2016, 2015, and 2014, respectively	(1,075)	(454)	919
Change in fair value of interest rate swap, net of deferred income tax of \$0, \$99, and \$49 for the years ended December 31, 2016, 2015 and 2014, respectively	—	190	96
Total other comprehensive (loss) income	(1,075)	(264)	1,010
Total comprehensive income	\$5,295	\$6,633	\$8,150
See Notes to Consolidated Financial Statements			

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY
Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2016, 2015, and 2014
(dollars in thousands, except per share amounts)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2013	\$ 8,482	\$ 11,537	\$ 46,082	\$ 305	\$ 66,406
Net income			\$ 7,140		7,140
Other comprehensive income				1,010	1,010
Restricted stock awards, stock incentive plan (14,009 shares)	35	(35)			—
Income tax expense on vesting of restricted stock		21			21
Income tax benefit on disqualifying disposition of stock options exercised		7			7
Stock options exercised (927 shares)	2	(2)			—
Stock based compensation expense		290			290
Issuance of common stock, dividend investment plan (31,904 shares)	80	620			700
Issuance of common stock, employee benefit plan (8,893 shares)	22	180			202
Dividends declared (\$0.77 per share)			(2,644)		(2,644)
Balance, December 31, 2014	\$ 8,621	\$ 12,618	\$ 50,578	\$ 1,315	\$ 73,132
Net income			6,897		6,897
Other comprehensive (loss)				(264)	(264)
Restricted stock awards, stock incentive plan (14,363 shares)	36	(36)			—
Income tax benefit on vesting of restricted stock		5			5
Stock-based compensation expense		328			328
Issuance of common stock, dividend investment plan (32,340 shares)	81	648			729
Issuance of common stock, employee benefit plan (8,030 shares)	20	167			187
Dividends declared (\$0.80 per share)			(2,793)		(2,793)
Balance, December 31, 2015	\$ 8,758	\$ 13,730	\$ 54,682	\$ 1,051	\$ 78,221
Net income			6,370		6,370
Other comprehensive (loss)				(1,075)	(1,075)
Restricted stock awards, stock incentive plan (13,196 shares)	33	(33)			—
Income tax benefit on vesting of restricted stock		2			2
Stock-based compensation expense		314			314
Issuance of common stock, dividend investment plan (23,180 shares)	58	475			533
Issuance of common stock, employee benefit plan (3,326 shares)	8	73			81
Retirement of common stock (89,607 shares)	(224)	(1,919)			(2,143)
Dividends declared (\$0.82 per share)			(2,887)		(2,887)
Balance, December 31, 2016	\$ 8,633	\$ 12,642	\$ 58,165	\$ (24)	\$ 79,416

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY
Consolidated Statements of Cash Flows
Years Ended December 31, 2016, 2015, and 2014
(dollars in thousands)

	2016	2015	2014
Cash Flows from Operating Activities			
Net income	\$6,370	\$6,897	7,140
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	932	843	772
Amortization of intangible and other assets	192	198	152
(Recovery of) Provision for loan losses	(188)	(227)	350
Valuation adjustments other real estate owned	12	288	—
Loss (gain) on foreclosure and sale of other real estate owned	90	(46)	(82)
Loss on the sale and disposal of premises and equipment	10	76	14
Loss on the sale of repossessed assets	1	—	4
(Gain) on the sale of securities	(98)	(124)	(990)
(Gain) on the redemption of trust preferred capital notes	—	(2,424)	—
Loss on derecognition of cash flow hedge	—	237	—
Fair value adjustment on derivative contract	(149)	(88)	—
Stock-based compensation expense	314	328	290
Premium amortization on securities, net	370	210	97
Deferred tax expense	207	432	142
Changes in assets and liabilities:			
(Increase) decrease in other assets	(1,095)	2,085	(451)
Increase (decrease) in other liabilities	2,732	(1,521)	(179)
Net cash provided by operating activities	\$9,700	\$7,164	\$7,259
Cash Flows from Investing Activities			
Proceeds from maturities, calls, and principal payments of securities available for sale	\$23,535	\$17,368	\$10,864
Proceeds from the sale of securities available for sale	11,356	3,653	8,546
Purchases of securities available for sale	(40,418)	(33,453)	(8,693)
Proceeds from the sale of restricted securities	850	1,325	284
Purchases of restricted securities	(22)	(413)	(900)
Proceeds from the sale of bank premises and equipment	—	7	—
Purchases of bank premises and equipment	(257)	(2,875)	(2,966)
Proceeds from the sale of other real estate owned	564	1,956	597
Proceeds from the sale of repossessed assets	4	10	29
Net (increase) in loans	(21,995)	(26,317)	(26,937)
Net cash (used in) investing activities	\$(26,383)	\$(38,739)	\$(19,176)
Cash Flows from Financing Activities			
Net increase in demand deposits, money market and savings accounts	\$57,448	\$49,690	\$20,210
Net (decrease) in certificates of deposit	(4,289)	(2,788)	(3,980)
Net (decrease) increase in Federal Home Loan Bank advances	(20,000)	(20,000)	17,750
Redemption of trust preferred capital notes	—	(4,793)	—
Issuance of common stock, employee benefit plan	81	187	202
Retirement of common stock	(2,143)	—	—
Cash dividends paid	(2,354)	(2,064)	(1,944)
Net cash provided by financing activities	\$28,743	\$20,232	\$32,238

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARY
Consolidated Statements of Cash Flows (continued)
Years Ended December 31, 2016, 2015, and 2014
(dollars in thousands)

	2016	2015	2014
Increase (decrease) in cash and cash equivalents	\$12,060	\$(11,343)	\$20,321
Cash and Cash Equivalents			
Beginning	23,221	34,564	14,243
Ending	\$35,281	\$23,221	\$34,564
Supplemental Disclosures of Cash Flow Information			
Cash payments for:			
Interest	\$1,099	\$1,442	\$1,916
Income taxes	\$—	\$583	\$1,985
Supplemental Schedule of Noncash Investing and Financing Activities:			
Unrealized (loss) gain on securities available for sale	\$(1,629)	\$(688)	\$1,392
Change in fair value of interest rate swap	\$—	\$52	\$145
Other real estate and repossessed assets acquired in settlement of loans	\$675	\$870	\$781
Loans made to finance the sale of other real estate owned	\$315	\$200	\$148
Issuance of common stock, dividend investment plan	\$533	\$729	\$700
Purchases of securities available for sale settled subsequent to year end	\$9,826	\$—	\$—
See Notes to Consolidated Financial Statements			

NOTE 1. Nature of Banking Activities and Significant Accounting Policies

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

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

Principles of Consolidation

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

Trust Assets

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

Cash and Cash Equivalents

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

Securities

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

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

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

Loans

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

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan fees collected and certain costs incurred related to loan originations are deferred and amortized as an adjustment to interest income over the life of the related loans. Deferred fees and costs are recorded as an adjustment to interest income using a method that approximates a constant yield. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 120 and 90 days delinquent, respectively, unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful.

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

Troubled Debt Restructurings (TDR)

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

Risks by Loan Portfolio Segments

One-to-Four-Family Residential Real Estate Lending

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

Commercial Real Estate Lending

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

Construction and Land Development Lending

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

Commercial and Industrial Lending

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

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

Consumer Lending

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

Allowance for Loan Losses

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

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

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

Bank Premises and Equipment

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

Other Real Estate Owned

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

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

Retirement Plans

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

Stock-Based Compensation Plan

During 2014, the Company's shareholders approved a stock incentive plan which allows key employees and directors to increase their personal financial interest in the Company. This plan permits the issuance of incentive stock options and non-qualified stock options and the award of stock appreciation rights, common stock, restricted stock, and phantom stock. The plan, as adopted, authorized the issuance of up to 500,000 shares of common stock. This plan is discussed more fully in Note 11.

Income Taxes

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

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

Advertising

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

Reclassifications

Certain reclassifications have been made to the 2015 financial statements to conform to reporting for 2016. The results of the reclassification are not considered material.

Earnings Per Common Share

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

The following table shows the weighted average number of shares used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock.

	2016	2015	2014
Weighted average number of common shares outstanding used to calculate basic earnings per share	3,518,848	3,495,334	3,438,348
Effect of dilutive common stock	—	—	298
Weighted average number of common shares outstanding used to calculate diluted earnings per share	3,518,848	3,495,334	3,438,646

There were no potentially dilutive securities outstanding in 2016 or 2015. There were no stock options excluded from the 2014 calculation of diluted earnings per common share because they were anti-dilutive.

Comprehensive Income

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

The components of the change in unrealized gains (losses) on securities during 2016, 2015, and 2014 were as follows:

	2016	2015	2014
Gross unrealized gain (loss)	\$(1,531)	\$(564)	\$2,382
Reclassification adjustment for realized (gain)	(98)	(124)	(990)
Net unrealized gain (loss) before taxes	(1,629)	(688)	1,392
Tax effect	554	234	(473)
	\$(1,075)	\$(454)	\$919

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

	Unrealized Gain (Loss) on Securities	Change in Fair Value of Interest Rate Swap	Post Retirement Benefit Plan	Total
December 31, 2014	\$ 1,466	\$ (190)	\$ 39	\$1,315
2015 Change	(454)	190	—	(264)
December 31, 2015	1,012	—	39	1,051
2016 Change	(1,075)	—	—	(1,075)
December 31, 2016	\$(63)	\$ —	\$ 39	\$(24)

Derivative Financial Instruments

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

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

derivative financial instruments see Note 14 to the Consolidated Financial Statements.

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Use of Estimates

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

Stock Repurchase Program

On June 15, 2016, the Corporation renewed the stock repurchase program to repurchase up to 150,000 shares of its common stock prior to June 30, 2017. During 2016, the Company purchased 89,607 shares of its Common Stock under its stock repurchase program at an average price of \$23.92. All of these shares were retired. There was no repurchase activity during 2015 and 2014. The maximum number of shares that may yet be purchased under the plan as of December 31, 2016 are 60,393.

Recent Accounting Pronouncements

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

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

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are

effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-05, “Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships.” The amendments in this ASU clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require de-designation of that hedging relationship provided that all other hedge accounting criteria remain intact. The amendments in this ASU are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-05 to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, “Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting.” The amendments in this ASU eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. In addition, the amendments in this ASU require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early Adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

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

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

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments”, to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years

beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, “Business Combinations (Topic 805): Clarifying the Definition of a Business”. The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a “set”) that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Company does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment”. The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit’s goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

NOTE 2. Securities

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
December 31, 2016 (in thousands)				
Obligations of U.S. government corporations and agencies	\$30,404	\$ 316	\$ (279)	\$30,441
Mortgage-backed securities	42,681	147	(456)	42,372
Obligations of states and political subdivisions	46,271	770	(592)	46,449
	\$119,356	\$ 1,233	\$ (1,327)	\$119,262
December 31, 2015 (in thousands)				
Obligations of U.S. government corporations and agencies	\$37,348	\$ 475	\$ (158)	\$37,665
Mortgage-backed securities	28,858	293	(220)	28,931
Obligations of states and political subdivisions	38,082	1,169	(24)	39,227
	\$104,288	\$ 1,937	\$ (402)	\$105,823

Carrying amounts of restricted securities at December 31, 2016 and 2015 were as follows:

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

The amortized cost and fair value of securities available for sale at December 31, 2016, by contractual maturity, are shown below. Maturities may differ from contractual maturities in mortgage-backed securities because the mortgages underlying the securities may be called or repaid without any penalties.

	Amortized Cost	Fair Value
	(in thousands)	
Due in one year or less	\$3,391	\$3,427
Due after one year through five years	22,446	22,981
Due after five years through ten years	43,965	43,717
Due after ten years	49,554	49,137
	\$119,356	\$119,262

During the twelve months ended December 31, 2016, the Company sold \$11.4 million in available for sale securities for a gross gain of \$108 thousand and a gross loss of \$10 thousand. During the twelve months ended December 31, 2015, the Company sold \$3.7 million in available for sale securities for a gross gain of \$124 thousand. During the twelve months ended December 31, 2014, the Company sold \$8.5 million in available for sale securities for a gross gain of \$990 thousand.

The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at December 31, 2016 and 2015 were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2016 (in thousands)						
Obligations of U.S. government corporations and agencies	\$ 19,129	\$ 279	\$ —	\$ —	\$ 19,129	\$ 279
Mortgage-backed securities	28,013	456	—	—	28,013	456
Obligations of states and political subdivisions	16,823	592	—	—	16,823	592
	\$ 63,965	\$ 1,327	\$ —	\$ —	\$ 63,965	\$ 1,327
December 31, 2015 (in thousands)						
Obligations of U.S. government corporations and agencies	\$ 21,296	\$ 143	\$ 1,985	\$ 15	\$ 23,281	\$ 158
Mortgage-backed securities	18,563	194	1,105	26	19,668	220
Obligations of states and political subdivisions	3,414	22	497	2	3,911	24
	\$ 43,273	\$ 359	\$ 3,587	\$ 43	\$ 46,860	\$ 402

Gross unrealized losses on available for sale securities included eighty (80) and forty-five (45) debt securities at December 31, 2016 and December 31, 2015, respectively. The Company evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The Company's mortgage-backed securities are issued by U.S. government agencies, which guarantee payments to investors regardless of the status of the underlying mortgages. Consideration is given to the length of time and the amount of an unrealized loss, the financial condition of the issuer, and the intent and ability of the Company to retain its investment in the issuer long enough to allow for an anticipated recovery in fair value. The fair value of a security reflects its liquidity as compared to similar instruments, current market rates on similar instruments, and the creditworthiness of the issuer. Absent any change in the liquidity of a security or the creditworthiness of the issuer, prices will decline as market rates rise and vice-versa. The primary cause of the unrealized losses at December 31, 2016 and December 31, 2015 was changes in market interest rates. Since the losses can be primarily attributed to changes in market interest rates and not expected cash flows or an issuer's financial condition, the unrealized losses are deemed to be temporary. The continuing economic recession involving housing, liquidity and credit were also contributing factors to the unrealized losses on these securities at December 31, 2016 and December 31, 2015. 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 \$2.9 million at December 31, 2016 were pledged for various purposes required by law.

NOTE 3. Loans

The composition of loans at December 31, 2016 and 2015 was as follows:

	December 31,	
	2016	2015
	(in thousands)	
Mortgage loans on real estate:		
Construction and land development	\$23,266	\$35,019
Secured by farmland	8,525	6,550
Secured by 1-4 family residential properties	227,966	229,651
Multifamily	3,566	3,975
Commercial	208,525	175,172
Loans to farmers	1,338	1,331
Commercial and industrial loans	30,341	29,366
Consumer installment loans	12,677	13,530
All other loans	738	979
Total loans (1)	\$516,942	\$495,573
Less: Allowance for loan losses	4,505	4,959
Net Loans	\$512,437	\$490,614

(1) Included in total loans were net deferred loan fees of \$183 thousand and \$103 thousand, respectively.

NOTE 4. Allowance for Loan Losses

Changes in the allowance for loan losses for the years December 31, 2016, 2015 and 2014 were as follows:

	December 31,		
	2016	2015	2014
	(in thousands)		
Balance, beginning	\$4,959	\$ 5,080	\$5,488
(Recovery of) provision for loan losses	(188)	(227)	350
Recoveries added to the allowance	341	562	725
Loan losses charged to the allowance	(607)	(456)	(1,483)
Balance, ending	\$4,505	\$ 4,959	\$5,080

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

December 31, 2016 (in thousands)								
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Current	Total Loans	90 or More Days Past Due Still Accruing	Nonaccrual Loans
Commercial - Non Real Estate:								
Commercial & Industrial	\$69	\$ 49	\$ —	\$ 118	\$30,223	\$ 30,341	\$ —	\$ 278
Commercial Real Estate:								
Owner Occupied	150	384	—	534	114,820	115,354	—	431
Non-owner occupied	—	54	135	189	92,982	93,171	—	1,066
Construction and Farmland:								
Residential	50	—	—	50	4,627	4,677	—	—
Commercial	499	—	—	499	26,615	27,114	—	—
Consumer:								
Installment	23	2	11	36	12,641	12,677	8	8
Residential:								
Equity Lines	66	—	—	66	31,240	31,306	—	132
Single family	444	51	166	661	195,999	196,660	—	5,076
Multifamily	—	—	—	—	3,566	3,566	—	—
All Other Loans	—	—	—	—	2,076	2,076	—	—
Total	\$1,301	\$ 540	\$ 312	\$ 2,153	\$514,789	\$ 516,942	\$ 8	\$ 6,991

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

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Total	\$3,371	\$ 481	\$ 2,042	\$ 5,894	\$489,679	\$ 495,573	\$ 307	\$ 5,285
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Allowance for loan losses by segment at December 31, 2016, December 31, 2015 and December 31, 2014 were as follows:

	As of and for the Twelve Months Ended December 31, 2016 (in thousands)							
	Construction and Farmland	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$ 775	\$ 2,322	\$ 1,268	\$ 211	\$ 109	\$ 53	\$ 221	\$ 4,959
Charge-Offs	—	(535)	—	—	(30)	(42)	—	(607)
Recoveries	144	124	8	11	49	5	—	341
Provision (recovery)	(469)	81	246	13	(59)	6	(6)	(188)
Ending balance	\$ 450	\$ 1,992	\$ 1,522	\$ 235	\$ 69	\$ 22	\$ 215	\$ 4,505
Ending balance:								
Individually evaluated for impairment	\$ —	\$ 268	\$ 102	\$ 15	\$ —	\$ —	\$ —	\$ 385
Ending balance: collectively evaluated for impairment	\$ 450	\$ 1,724	\$ 1,420	\$ 220	\$ 69	\$ 22	\$ 215	\$ 4,120
Loans:								
Ending balance	\$ 31,791	\$ 231,532	\$ 208,525	\$ 30,341	\$ 12,677	\$ 2,076	\$ —	\$ 516,942
Ending balance individually evaluated for impairment	\$ 1,320	\$ 8,608	\$ 2,864	\$ 581	\$ 7	\$ —	\$ —	\$ 13,380
Ending balance collectively evaluated for impairment	\$ 30,471	\$ 222,924	\$ 205,661	\$ 29,760	\$ 12,670	\$ 2,076	\$ —	\$ 503,562

	As of and for the Twelve Months Ended December 31, 2015 (in thousands)							
	Construction and Farmland	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$ 951	\$ 1,977	\$ 1,347	\$ 464	\$ 103	\$ 42	\$ 196	\$ 5,080
Charge-Offs	(166)	(152)	(47)	—	(66)	(25)	—	(456)
Recoveries	75	142	115	181	33	16	—	562
Provision (recovery)	(85)	355	(147)	(434)	39	20	25	(227)
Ending balance	\$ 775	\$ 2,322	\$ 1,268	\$ 211	\$ 109	\$ 53	\$ 221	\$ 4,959
Ending balance:								
Individually evaluated for impairment	\$ 10	\$ 423	\$ 141	\$ 2	\$ —	\$ —	\$ —	\$ 576
Ending balance: collectively evaluated for impairment	\$ 765	\$ 1,899	\$ 1,127	\$ 209	\$ 109	\$ 53	\$ 221	\$ 4,383
Loans:								
Ending balance	\$ 41,569	\$ 233,626	\$ 175,172	\$ 29,366	\$ 13,530	\$ 2,310	\$ —	\$ 495,573
Ending balance individually evaluated for impairment	\$ 1,392	\$ 7,209	\$ 4,555	\$ 847	\$ —	\$ —	\$ —	\$ 14,003
Ending balance collectively evaluated for impairment	\$ 40,177	\$ 226,417	\$ 170,617	\$ 28,519	\$ 13,530	\$ 2,310	\$ —	\$ 481,570

Ending balance collectively
evaluated for impairment

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

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

Beginning with the quarter ended December 31, 2015, the Company changed its allowance methodology for the risk scale used in calculating the environmental factors portion of the general reserves assigned to unimpaired credits. During this quarter, management determined it necessary to adjust each of the risk scores assigned to all nine current environmental factors due to changes that had occurred both internally and outside of the Company that have an impact on payment defaults, collateral values, risk ratings, etc. The Company believes that the revised risk scale is more indicative of the losses and risks inherent in the portfolio.

The following table represents the effect on the loan loss provision for the year ended December 31, 2015 as a result of the change in allowance methodology from that used in prior periods. No similar changes to the methodology were made in the current period.

(in thousands)	Calculated Provision Based on Current Methodology	Calculation Provision Based on Prior Methodology	Difference
Portfolio Segment:			
Construction and Farmland	\$ (85)	\$ (118)	\$ 33
Residential Real Estate	355	173	182
Commercial Real Estate	(147)	(280)	133
Commercial	(434)	(457)	23
Consumer	39	28	11
All Other Loans	20	19	1
Total, excluding unallocated	\$ (252)	\$ (635)	\$ 383

Impaired loans by class at December 31, 2016 and December 31, 2015 were as follows:

	As of and for the Year Ended December 31, 2016 (in thousands)				
	Unpaid Principal Balance	Recorded Investment (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 311	\$ 299	\$ —	\$ 356	\$ 21
Commercial Real Estate:					
Owner Occupied	869	772	—	778	15
Non-owner occupied	1,298	1,066	—	1,137	13
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	1,320	1,324	—	1,358	75
Consumer:					
Installment	8	8	—	9	—
Residential:					
Equity lines	17	17	—	18	—
Single family	7,072	6,849	—	6,930	170
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$10,895	\$ 10,335	\$ —	\$ 10,586	\$ 294
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 283	\$ 283	\$ 15	\$ 298	\$ 14
Commercial Real Estate:					
Owner Occupied	203	203	37	205	10
Non-owner occupied	824	826	65	834	37
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	—	—	—	—	—
Residential:					
Equity lines	458	115	56	120	—
Single family	1,678	1,638	212	1,676	60
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$3,446	\$ 3,065	\$ 385	\$ 3,133	\$ 121
Total:					
Commercial	\$ 594	\$ 582	\$ 15	\$ 654	\$ 35
Commercial Real Estate	3,194	2,867	102	2,954	75
Construction and Farmland	1,320	1,324	—	1,358	75
Consumer	8	8	—	9	—
Residential	9,225	8,619	268	8,744	230
Other	—	—	—	—	—
Total	\$14,341	\$ 13,400	\$ 385	\$ 13,719	\$ 415

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

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	As of and for the Year Ended December 31, 2015 (in thousands)				
	Unpaid Principal Balance	Recorded Investment (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 747	\$ 534	\$ —	\$ 749	\$ 18
Commercial Real Estate:					
Owner Occupied	2,146	1,964	—	1,999	19
Non-owner occupied	1,174	1,093	—	1,108	15
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	337	310	—	325	—
Residential:					
Equity lines	149	145	—	145	5
Single family	4,407	4,288	—	4,245	126
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$ 8,960	\$ 8,334	\$ —	\$ 8,571	\$ 183
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 313	\$ 313	\$ 2	\$ 328	\$ 15
Commercial Real Estate:					
Owner Occupied	207	208	39	210	10
Non-owner occupied	1,291	1,295	102	1,311	69
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	1,081	1,085	10	1,109	48
Residential:					
Equity lines	551	216	86	221	3
Single family	2,596	2,575	337	2,600	76
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	\$ 6,039	\$ 5,692	\$ 576	\$ 5,779	\$ 221
Total:					
Commercial	\$ 1,060	\$ 847	\$ 2	\$ 1,077	\$ 33
Commercial Real Estate	4,818	4,560	141	4,628	113
Construction and Farmland	1,418	1,395	10	1,434	48
Residential	7,703	7,224	423	7,211	210
Other	—	—	—	—	—
Total	\$ 14,999	\$ 14,026	\$ 576	\$ 14,350	\$ 404

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

For the year ended December 31, 2014, the average recorded investment of impaired loans was \$19.1 million. The interest income recognized on impaired loans was \$454 thousand in 2014.

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

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

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

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

INTERNAL RISK RATING GRADES	As of December 31, 2016 (in thousands)						Total
	Pass	Pass Monitored	Special Mention	Substandard	Doubtful	Loss	
Commercial - Non Real Estate:							
Commercial & Industrial	\$25,951	\$ 3,858	\$ 170	\$ 362	\$ —	\$ —	-\$30,341
Commercial Real Estate:							
Owner Occupied	99,365	13,050	1,766	742	431	—	115,354
Non-owner occupied	60,259	30,515	891	1,506	—	—	93,171
Construction and Farmland:							
Residential	4,627	50	—	—	—	—	4,677
Commercial	21,105	5,349	314	346	—	—	27,114
Residential:							
Equity Lines	30,791	382	—	17	116	—	31,306
Single family	182,404	6,850	724	6,533	149	—	196,660
Multifamily	3,032	534	—	—	—	—	3,566
All other loans	2,076	—	—	—	—	—	2,076
Total	\$429,610	\$ 60,588	\$ 3,865	\$ 9,506	\$ 696	\$ —	-\$504,265

INTERNAL RISK RATING GRADES	As of December 31, 2015 (in thousands)						Total
	Pass	Pass Monitored	Special Mention	Substandard	Doubtful	Loss	
Consumer Credit Exposure by Payment Activity							
			Performing	Nonperforming			
			\$ 12,641	\$ 36			
Commercial - Non Real Estate:							
Commercial & Industrial	\$25,375	\$ 3,175	\$ 335	\$ 364	\$ 117	\$ —	-\$29,366
Commercial Real Estate:							
Owner Occupied	90,230	12,553	4,521	1,416	987	—	109,707
Non-owner occupied	42,988	21,072	—	1,405	—	—	65,465
Construction and Farmland:							
Residential	8,559	—	—	—	—	—	8,559
Commercial	20,391	10,886	1,395	338	—	—	33,010
Residential:							
Equity Lines	30,267	3,878	—	145	131	—	34,421
Single family	170,168	19,086	950	4,600	426	—	195,230
Multifamily	3,975	—	—	—	—	—	3,975
All other loans	2,265	45	—	—	—	—	2,310
Total	\$394,218	\$ 70,695	\$ 7,201	\$ 8,268	\$ 1,661	\$ —	-\$482,043

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

One consumer loan totaling \$5 thousand was rated below Pass at December 31, 2016. No consumer loans were rated below Pass at December 31, 2015.

NOTE 5. Troubled Debt Restructurings

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

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

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

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

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

• The borrower receives a reduction of the accrued interest.

There were twenty-six (26) troubled debt restructured loans totaling \$7.3 million at December 31, 2016. At December 31, 2015, there were twenty-three (23) troubled debt restructured loans totaling \$7.5 million. Six loans, totaling \$1.6 million, were in nonaccrual status at December 31, 2016. Two loans, totaling \$526 thousand, were in nonaccrual status at December 31, 2015. There were no outstanding commitments to lend additional amounts to troubled debt restructured borrowers at December 31, 2016.

The following tables set forth information on the Company's troubled debt restructurings by class of financing receivable occurring during the years ended December 31, 2016, 2015 and 2014:

		For the Year Ended December 31, 2016 (in thousands)	
		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Commercial Real Estate:			
Non-owner occupied	1	\$ 736	\$ 736
Residential:			
Single family	4	560	463
Total	5	\$ 1,296	\$ 1,199

		For the Year Ended December 31, 2015 (in thousands)	
		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Residential:			
Single family	3	\$ 794	\$ 794
Total	3	\$ 794	\$ 794

		For the Year Ended December 31, 2014 (in thousands)	
		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Commercial - Non Real Estate:			
Commercial & Industrial	2	\$ 941	\$ 639
Construction and Farmland:			
Commercial	1	1,520	1,050
Residential:			
Equity	1	69	69
Single family	1	216	216
Total	5	\$ 2,746	\$ 1,974

During the twelve months ended December 31, 2016, the Company restructured five loans by granting concessions to borrowers experiencing financial difficulties. One residential loan and one commercial real estate loan was modified by extending the amortization period and reducing the interest rate. Two residential loans were modified by reducing the payments to be affordable for the borrower. One residential loan was modified by changing payments to interest-only in order to reduce the monthly payment for a period of time.

During the twelve months ended December 31, 2015, the Company restructured three loans by granting concessions to borrowers experiencing financial difficulties. Two single family residential loans were modified by changing the amortization period. One single family residential loan was modified by changing the amortization period and interest rate in order to reduce the monthly payments.

During the twelve months ended December 31, 2014, the Company restructured five loans by granting concessions to borrowers experiencing financial difficulties. Two commercial and industrial loans were modified by reducing the payment amount. One commercial construction and farmland loan was modified by forgiving a portion of the loan balance and changing the terms of the loan. One single family residential loan was modified by reducing the payment amount. One residential equity loan was modified by changing payments to interest-only in order to reduce the monthly payment for a period of time.

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

	For the Year Ended December 31, 2016 (in thousands) Number of Recorded Investment Contracts
Residential:	
Single family	2 \$ 588
Total	2 \$ 588

	For the Year Ended December 31, 2015 (in thousands) Number of Recorded Investment Contracts
Commercial - Non Real Estate:	
Commercial & Industrial	1 \$ 267
Residential:	
Equity	1 60
Single family	2 627
Total	4 \$ 954

	For the Year Ended December 31, 2014 (in thousands) Number of Recorded Investment Contracts
Construction and Farmland:	
Commercial	1 \$ 79
Total	1 \$ 79

Management defines default as over 30 days contractually past due under the modified terms or the foreclosure and repossession of the collateral and charge-off of the loan during the twelve month period subsequent to the modification.

NOTE 6. Bank Premises and Equipment, Net

The major classes of bank premises and equipment and the total accumulated depreciation at December 31, 2016 and 2015 were as follows:

	December 31,	
	2016	2015
	(in thousands)	
Land	\$6,729	\$6,729
Buildings and improvements	17,928	18,632
Furniture and equipment	6,876	8,824
	\$31,533	\$34,185
Less accumulated depreciation	11,364	13,221
Bank premises and equipment, net	\$20,169	\$20,964

Depreciation expense on buildings and improvements was \$484 thousand, \$470 thousand, and \$446 thousand for the years ended 2016, 2015, and 2014, respectively. Depreciation expense on furniture and equipment was \$448 thousand, \$373 thousand, and \$326 thousand for the years ended 2016, 2015, and 2014, respectively.

As of December 31, 2016, one facility was under an operating lease, which expires in 2030. This lease requires payment of certain operating expenses and contains renewal options. The total minimum rental commitment at December 31, 2016 under this lease was due as follows:

	December 31,
	2016
	(in thousands)
2017	\$ 200
2018	200
2019	200
2020	213
2021	220
Thereafter	1,944
	\$ 2,977

The total building and equipment rental expense was \$236 thousand, \$271 thousand, and \$135 thousand in 2016, 2015, and 2014, respectively.

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

NOTE 7. Deposits

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

	December 31,	
	2016	2015
	(in thousands)	
Noninterest bearing demand deposits	\$208,948	\$186,133
Savings and interest bearing demand deposits:		
NOW accounts	\$85,944	\$86,199
Money market accounts	126,632	105,560
Regular savings accounts	94,271	80,455
	\$306,847	\$272,214
Time deposits:		
Balances of less than \$250,000	\$67,159	\$80,444
Balances of \$250,000 and more	20,923	11,927
	\$88,082	\$92,371
	\$603,877	\$550,718

Time deposits with balances of less than \$250,000 include \$2.2 million and \$12.9 million in brokered certificates of deposit at December 31, 2016 and 2015, respectively. There were no time deposits with balances of \$250,000 and more in brokered certificates of deposit at December 31, 2016 and 2015, respectively.

The outstanding balance of time deposits at December 31, 2016 was due as follows:

	December 31, 2016 (in thousands)
2017	\$ 69,825
2018	8,158
2019	4,087
2020	1,138
2021	4,863
Thereafter 11	\$ 88,082

Deposit overdrafts reclassified as loans totaled \$272 thousand and \$116 thousand at December 31, 2016 and 2015, respectively.

NOTE 8. Borrowings

The Company, through its subsidiary bank, borrows funds in the form of federal funds purchased and Federal Home Loan Bank advances.

Federal fund lines of credit are extended to the Bank by nonaffiliated banks with which a correspondent banking relationship exists. The line of credit amount is determined by the creditworthiness of the Bank and, in particular, its regulatory capital ratios, which are discussed in Note 16. Federal funds purchased generally mature each business day. The following table summarizes information related to federal funds purchased for the years ended December 31, 2016 and 2015:

	December 31,	
	2016	2015
	(dollars in thousands)	
Balance at year-end	\$—	\$—
Average balance during the year	\$73	\$1,154
Average interest rate during the year	0.81 %	0.92 %
Maximum month-end balance during the year	\$1,302	\$8,329
Gross lines of credit at year-end	\$36,000	\$36,000
Unused lines of credit at year-end	\$36,000	\$36,000

As of December 31, 2016, the Company also had a \$5.0 million gross and unused line of credit, in addition to the \$36.0 million in federal funds lines of credit listed in the table above.

As of December 31, 2016, Company had remaining credit availability in the amount of \$150.2 million at the Federal Home Loan Bank of Atlanta. This line may be utilized for short and/or long-term borrowing. Advances on the line are secured by all of the Company's eligible first lien residential real estate loans on one-to-four-unit, single-family dwellings; multi-family dwellings; home equity lines of credit; and commercial real estate loans. The amount of the available credit is limited to a percentage of the estimated market value of the loans as determined periodically by the FHLB of Atlanta. The amount of the available credit is also limited to 20% of total Bank assets.

The Company had no long-term borrowings with the FHLB at December 31, 2016. The Company also had no short-term borrowings with the FHLB at December 31, 2016. The Company had a \$15.0 million irrevocable letter of credit at December 31, 2016 with the FHLB to secure public deposits. The Company had \$20.0 million in borrowings with the FHLB at December 31, 2015.

NOTE 9. Income Taxes

The Company files income tax returns with the United States of America and the Commonwealth of Virginia. With few exceptions, the Company is no longer subject to federal, state, or local income tax examinations for years prior to 2013.

The net deferred tax asset at December 31, 2016 and 2015 consisted of the following components:

	December 31,	
	2016	2015
	(in thousands)	
Deferred tax assets:		
Allowance for loan losses	\$1,525	\$1,678
Deferred compensation	117	116
Accrued postretirement benefits	40	47
Home equity origination costs	73	59
Other real estate owned valuation allowance	—	80
Nonaccrual interest	151	211
Securities available for sale	32	—
Other	193	120
	\$2,131	\$2,311
Deferred tax liabilities:		
Property and equipment	\$814	\$812
Securities available for sale	—	522
	\$814	\$1,334
Net deferred tax asset	\$1,317	\$977

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

Income tax expense for the years ended December 31, 2016, 2015 and 2014 consisted of the following components:

	December 31,		
	2016	2015	2014
	(in thousands)		
Current tax expense	\$2,346	\$2,001	\$1,926
Deferred tax expense	207	432	142
	\$2,553	\$2,433	\$2,068

The following table reconciles income tax expense to the statutory federal corporate income tax amount, which was calculated by applying the federal corporate income tax rate to pre-tax income for the years ended December 31, 2016, 2015 and 2014.

	December 31,		
	2016	2015	2014
	(in thousands)		
Statutory federal corporate tax amount	\$3,034	\$3,172	\$3,131
Tax-exempt interest (income)	(387)	(404)	(454)
Officer insurance loss	15	11	9
Net tax credits	(126)	(105)	(593)
Other	17	(241)	(25)
	\$2,553	\$2,433	\$2,068

The effective tax rates were 28.62%, 26.08%, and 22.46%, for years ended December 31, 2016, 2015, and 2014, respectively.

NOTE 10. Postretirement Benefit Plans

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

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

The following amounts that have not been recognized in the net periodic benefit cost of the postretirement benefit plan for the year ended December 31, 2016 but are included in other comprehensive income: unrecognized net actuarial gain of \$39 thousand. The transition obligation included in other comprehensive income and expected to be recognized in the net periodic benefit cost of the postretirement benefit plan during 2017 is \$4 thousand.

The following tables provide a reconciliation of the changes in the benefit obligations and fair value of assets for 2016, 2015, and 2014 and a statement of the funded status at December 31, 2016, 2015 and 2014 for the postretirement benefit plans of the Company. The Company uses a December 31st measurement date for its plans.

	Postretirement Benefits Plan		
	2016	2015	2014
	(in thousands)		
Change in Benefit Obligation:			
Benefit obligation, beginning	\$ 128	\$ 137	\$ 138
Service cost	—	—	—
Interest cost	4	4	5
Actuarial (gain) loss	(7)	(6)	1
Benefits paid	(7)	(7)	(7)
Settlement loss	—	—	—
Benefit obligation, ending	\$ 118	\$ 128	\$ 137
Change in Plan Assets:			
Fair value of plan assets, beginning	\$ —	\$ —	\$ —
Actual return on plan assets	—	—	—
Employer contributions	7	7	7
Benefits paid	(7)	(7)	(7)
Fair value of plan assets, ending	\$ —	\$ —	\$ —

	Postretirement Benefits Plan		
	2016	2015	2014
	(in thousands)		
Funded Status:			
Funded status	\$ (118)	\$ (128)	\$ (137)
Unrecognized net actuarial loss	—	—	—
Unrecognized net transition obligation	—	—	—
Unrecognized prior service cost	—	—	—
Accrued benefits	\$ (118)	\$ (128)	\$ (137)
Amounts Recognized in Consolidated Balance Sheets:			
Prepaid benefit cost	\$ —	\$ —	\$ —
Accrued liability	(118)	(128)	(137)
	\$ (118)	\$ (128)	\$ (137)
Amounts Recognized in Accumulated Other Comprehensive Income:			
Net actuarial (gain)	\$ (58)	\$ (58)	\$ (58)
Net transition obligation	—	—	—
Deferred tax liability	19	19	19
	\$ (39)	\$ (39)	\$ (39)

The following tables provide the components of net periodic benefit cost of the postretirement benefit plan for the years ended December 31, 2016, 2015, and 2014:

	Postretirement Benefits Plan		
	2016	2015	2014
	(in thousands)		
Components of Net Periodic Benefit Cost:			
Service cost	\$ —	\$ —	\$ —
Interest cost	4	4	5
Expected return on plan assets	—	—	—
Amortization of prior service costs	—	—	—
Amortization of transition obligation	—	—	—
Recognized net loss due to settlement	—	—	—
Amortization of net actuarial gain	(6)	(6)	(9)
Net periodic benefit cost	\$ (2)	\$ (2)	\$ (4)

The benefit obligation for the postretirement benefit plan was calculated using a weighted average discount rate of 3.00% for 2016, 3.25% for 2015, and 3.00% for 2014. For measurement purposes, a 10.00% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2017 and 2018, 8.00% for 2019 and 2020, and 6.00% for 2021 and thereafter. If these rates were increased by 1.00% in each year, the benefit obligation at December 31, 2016 would have increased by \$4 thousand and the net periodic benefit cost for 2016 would have increased by less than \$1 thousand. If these rates were decreased by 1.00% in each year, the benefit obligation at December 31, 2016 would have decreased by \$3 thousand and the net periodic benefit cost for 2016 would have decreased by less than \$1 thousand.

Estimated future benefit payments at December 31, 2016, which reflect expected future service, as appropriate, were as follows:

	Postretirement Benefits (in thousands)
2017	\$ 14
2018	14
2019	14
2020	13
2021	12
2022 - 2026	45

NOTE 11. Stock-Based Compensation

The exercise price of stock options granted under this plan, both incentive and non-qualified, cannot be less than the fair market value of the common stock on the date that the option is granted. The maximum term for an option granted under this plan is ten years and options granted may be subject to a vesting schedule. All of the non-qualified stock options granted under the plan had a ten year term and were subject to a vesting period. The following table summarizes options outstanding at December 31, 2014. There was no stock option activity during 2016 and 2015.

	2014	
	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	10,000	\$ 21.55
Granted	—	—
Exercised	(927)	21.55
Forfeited	(9,073)	21.55
Outstanding, end of year	—	\$ —
Exercisable, end of year	—	\$ —
Weighted average fair value of options granted during the year		\$ —

Restricted Stock provides grantees with rights to shares of common stock upon completion of a service period or achievement of Company performance measures. During the restriction period, all shares are considered outstanding and dividends are paid to the grantee. Outside directors are periodically granted restricted shares which vest over a period of less than nine months. During 2016, executive officers were granted restricted shares which vest over a three year service period and restricted shares which vest based on meeting performance measures over a one year period. Vesting schedules were unchanged from the two prior years. The following table presents the activity for Restricted Stock for the years ended December 31, 2016, 2015 and 2014:

	Twelve Months Ended December 31,					
	2016		2015		2014	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested, beginning of period	14,401	\$ 22.98	15,151	\$ 22.27	17,050	\$ 19.92
Granted	14,650	23.07	14,650	23.85	14,900	23.50
Vested	(13,196)	23.00	(14,363)	23.09	(14,009)	20.75
Forfeited	(954)	23.00	(1,037)	23.50	(2,790)	22.11
Nonvested, end of period	14,901	\$ 23.05	14,401	\$ 22.98	15,151	\$ 22.27

The Company recognizes compensation expense over the restricted period. Compensation expense was \$314 thousand, \$328 thousand, and \$290 thousand during December 31, 2016, 2015, and 2014, respectively. The total grant date fair value of Restricted Stock which vested was \$303 thousand and \$332 thousand for the years ended December 31, 2016 and 2015, respectively. Unrecognized compensation cost related to unvested Restricted Stock was \$63 thousand at December 31, 2016. This amount is expected to be recognized over a weighted average period of one year.

NOTE 12. Employee Benefits

The Company has established an Employee Stock Ownership Plan (ESOP) to provide additional retirement benefits to substantially all employees. Contributions can be made to the Bank of Clarke County Employee Retirement Trust to be used to purchase the Company's common stock. There were no contributions in 2016, 2015, and 2014.

The Company sponsors a 401(k) savings plan under which eligible employees may defer a portion of salary on a pretax basis, subject to certain IRS limits. Prior to January 1, 2007, the Company matched 50 percent of employee contributions, on a maximum of six percent of salary deferred, with Company common stock or cash, as elected by each employee. The shares for this purpose are provided principally by the Company's employee stock ownership plan (ESOP), supplemented, as needed, by newly issued shares. In conjunction with amending the pension plan, the 401(k) plan was amended, effective January 1, 2007, to include a non-elective safe-harbor employer contribution and an age-weighted employer contribution. Each December 31st, qualifying employees will receive a non-elective safe-harbor contribution equal to three percent of their salary for that year. Also, each December 31st, qualifying employees will receive an additional contribution based on their age and years of service. The percentage of salary for the age-weighted contribution increases on both factors, age and years of service, with a minimum of one percent of salary and a maximum of ten percent of salary. Contributions under the plan amounted to \$990 thousand in 2016, \$956 thousand in 2015, and \$927 thousand in 2014.

The Company has established an Executive Supplemental Income Plan for certain key employees. Benefits are to be paid in monthly installments following retirement or death. The agreement provides that if employment is terminated for reasons other than death or disability prior to age 65, the amount of benefits could be reduced or forfeited. The executive supplemental income benefit liability was \$64 thousand and \$71 thousand at December 31, 2016 and 2015, respectively. The executive supplemental income benefit expense, based on the present value of the retirement benefits, was \$29 thousand in 2016, \$29 thousand in 2015, and \$21 thousand in 2014. The plan is unfunded; however, life insurance has been acquired on the lives of these employees in amounts sufficient to discharge the plan's obligations.

NOTE 13. Commitments and Contingencies

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

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

As a member of the Federal Reserve System, the Bank is required to maintain certain average reserve balances. These reserve balances include usable vault cash and amounts on deposit with the Federal Reserve Bank. For the final weekly reporting period in the years ended December 31, 2016 and 2015, the amount of daily average required balances were approximately \$1.3 million and \$1.2 million, respectively. For both periods, these required amounts were met by vault cash and no additional amount was required to be on deposit with the Federal Reserve Bank. In addition, the Bank was required to maintain a total compensating balance on deposit with two correspondent banks in the amount of \$250 thousand at December 31, 2016 and 2015.

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

NOTE 14. Derivative Instruments and Hedging Activities

Interest Rate Swaps

The Company uses interest rate swaps to reduce interest rate risk and to manage interest expense. By entering into these agreements, the Company converts floating rate debt into fixed rate debt, or alternatively, converts fixed rate debt into floating rate debt. Interest differentials paid or received under the swap agreements are reflected as adjustments to interest expense. These interest rate swap agreements are derivative instruments that qualify for hedge accounting as discussed in Note 1. The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counterparty, the risk in these transactions is the cost of

replacing the agreements at current market rates.

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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 had an expiration date of December 1, 2016. Under the terms of the agreement, the Company paid interest quarterly at a fixed rate of 2.85% and received interest quarterly at a variable rate of three month LIBOR. The variable rate reset on each interest payment date. This agreement was designated as a cash-flow hedge at inception of the contract until the redemption of the trust preferred capital notes on July 29, 2015. As a result of the redemption, the derivative contract was no longer classified as a cash flow hedge and was recorded in the balance sheet at its fair value with changes in fair value recorded in Other operating income in the Consolidated Statements of Income.

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

	2016		2015	
	Balance Sheet	Fair	Balance Sheet	Fair
	Location	Value	Location	Value
	(dollars in thousands)			
Derivatives not designated as hedging instruments under GAAP				
Interest rate swap contracts	Other Liabilities	\$	Other Liabilities	\$ 149

The following tables present the effect of the derivative instrument on the Consolidated Statements of Income for December 31, 2016, 2015, and 2014:

Derivatives not designated as hedging instruments under GAAP	Location of Gain (Loss) Recognized in Income	Amount of Gain (Loss) Recognized in Income		
		2016	2015	2014
		(dollars in thousands)		
Interest rate swap contracts, net of tax	Other operating income	\$ 149	\$ 88	—

The balance of the interest rate swap liability was \$237 thousand at the time of the redemption of the Company's trust preferred debt on July 29, 2015. The total amount recorded in accumulated other comprehensive income at that date was reclassified to earnings due to the derecognition of the cash flow hedge. Subsequent to the redemption of the debt and reclassification, the interest rate swap derivative was adjusted to its fair value resulting in a \$149 thousand and \$88 thousand gain recorded in Other operating income in the Consolidated Statements of Income for the twelve months ended December 31, 2016 and 2015, respectively.

NOTE 15. Transactions with Directors and Officers

The Bank grants loans to and accepts deposits from its directors, principal officers and related parties of such persons during the ordinary course of business. The aggregate balance of loans to directors, principal officers and their related parties was \$4.7 million and \$4.0 million at December 31, 2016 and 2015, respectively. These balances reflect total principal additions of \$5.0 million and total principal payments of \$4.3 million, during 2016. The aggregate balance of deposits from directors, principal officers and their related parties was \$15.6 million and \$12.9 million at December 31, 2016 and 2015, respectively. Adjustments were made to prior year amounts for directors and officers that are no longer considered to be related parties.

NOTE 16. Capital Requirements

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

In July 2013, the Federal Reserve Bank issued a final rule that makes technical changes to its market risk capital rules to align them with the BASEL III regulatory capital framework and meet certain requirements of the Dodd-Frank Act. The phase-in period for the final rules began January 1, 2015 with full compliance with the final rules to be phased in by January 1, 2019. As a part of this final rule, the Bank was required to begin calculating and disclosing Common Equity Tier 1 Capital to risk weighted assets in 2015. Although not required by the final rule, the Company also began calculating and disclosing Common Equity Tier 1 Capital to risk weighted assets in 2015. In addition to the minimum regulatory capital required for capital adequacy purposes, the Company is required to maintain a minimum Capital Conservation Buffer, in the form of common equity, in order to avoid restrictions on capital distributions and discretionary bonuses. The required amount of the Capital Conservation Buffer was 0.625% on January 1, 2016 and will increase by 0.625% each year until it reaches 2.5% on January 1, 2019. The Capital Conservation Buffer is applicable to all ratios except the leverage ratio, which is noted below as Tier 1 Capital to Average Assets.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total capital, Tier 1 capital, and common equity Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that the Company and the Bank met all capital adequacy requirements to which they are subject at December 31, 2016 and 2015.

At December 31, 2016, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 leverage, and common equity Tier 1 ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category.

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The following table presents the Company's and the Bank's actual capital amounts and ratios at December 31, 2016 and 2015:

	Actual	Minimum	Minimum	Minimum	Minimum	Minimum	Minimum	
	Amount	Ratio	Requirement	Requirement	Requirement	Requirement	Requirement	
	(dollars in thousands)		(dollars in thousands)		(dollars in thousands)		(dollars in thousands)	
December 31, 2016:								
Common Equity Tier 1 Capital to Risk Weighted Assets								
Consolidated	\$79,440	15.68%	\$22,798	4.50%	N/A			
Bank of Clarke County	\$76,124	15.11%	\$22,666	4.50%	\$32,740	6.50%		
Total Capital to Risk Weighted Assets								
Consolidated	\$83,977	16.58%	\$40,531	8.00%	N/A			
Bank of Clarke County	\$80,640	16.01%	\$40,295	8.00%	\$50,369	10.00%		
Tier 1 Capital to Risk Weighted Assets								
Consolidated	\$79,440	15.68%	\$30,398	6.00%	N/A			
Bank of Clarke County	\$76,124	15.11%	\$30,221	6.00%	\$40,295	8.00%		
Tier 1 Capital to Average Assets								
Consolidated	\$79,440	11.84%	\$26,848	4.00%	N/A			
Bank of Clarke County	\$76,124	11.40%	\$26,711	4.00%	\$33,389	5.00%		
December 31, 2015:								
Common Equity Tier 1 Capital to Risk Weighted Assets								
Consolidated	\$77,170	15.22%	\$22,819	4.50%	N/A			
Bank of Clarke County	\$74,034	14.72%	\$22,633	4.50%	\$32,692	6.50%		
Total Capital to Risk Weighted Assets								
Consolidated	\$82,156	16.20%	\$40,567	8.00%	N/A			
Bank of Clarke County	\$78,997	15.71%	\$40,237	8.00%	\$50,296	10.00%		
Tier 1 Capital to Risk Weighted Assets								
Consolidated	\$77,170	15.22%	\$30,425	6.00%	N/A			
Bank of Clarke County	\$74,034	14.72%	\$30,177	6.00%	\$40,237	8.00%		
Tier 1 Capital to Average Assets								
Consolidated	\$77,170	12.13%	\$25,438	4.00%	N/A			
Bank of Clarke County	\$74,034	11.65%	\$25,426	4.00%	\$31,783	5.00%		

NOTE 17. Restrictions On Dividends, Loans and Advances

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

to the Company would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements.

At December 31, 2016, the Bank's retained earnings available for the payment of dividends to the Company was \$6.8 million. Accordingly, \$69.3 million of the Company's equity in the net assets of the Bank was restricted at December 31, 2016. Funds available for loans or advances by the Bank to the Company amounted to \$1.1 million at December 31, 2016.

NOTE 18. Dividend Investment Plan

The Company has a Dividend Investment Plan, which allows participants' dividends to purchase additional shares of common stock at its fair market value on each dividend record date. During 2016, the Company amended the Plan to provide that shares of common stock purchased through the Plan would be purchased at a price equal to the market price of the shares. Prior to this date, the Plan allowed participants' dividends to purchase additional shares of common stock at 95% of its fair market value. Our board of directors determined to eliminate the discount for purchases of shares in order to reflect current best practices and market standards for dividend reinvestment plans generally and among our peers. No other changes have been made to the operation of the dividend reinvestment features of the Plan, and current participants will remain enrolled in the Plan under their current methods of participation unless they choose to alter their enrollment following the procedures described in this prospectus.

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

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

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

At December 31, 2016 and 2015, the following financial instruments were outstanding whose contract amounts represent credit risk:

	2016	2015
	(dollar in thousands)	
Commitments to extend credit	\$27,144	\$18,247
Unfunded commitments under lines of credit	100,530	90,287
Commercial and standby letters of credit	5,897	4,286

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

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

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in granting loans to customers. The Bank holds collateral supporting these commitments if it is deemed necessary. At December 31, 2016, \$5.0 million of the outstanding letters of credit were collateralized.

The Bank has cash accounts in other commercial banks. The amount on deposit in these banks at December 31, 2016 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$1.2 million.

NOTE 20. Trust Preferred Capital Notes

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

NOTE 21. Quarterly Condensed Statements of Income - Unaudited

The Company's quarterly net income, net income per common share and dividends per common share during 2016 and 2015 are summarized as follows:

	2016 Quarter Ended			
	March 31	June 30	September 30	December 31
	(in thousands, except per share amounts)			
Total interest and dividend income	\$6,421	\$6,642	\$ 6,279	\$ 6,443
Net interest income after provision for loan losses	6,035	6,345	6,162	6,364
Noninterest income	1,635	1,738	1,687	1,609
Noninterest expenses	5,554	5,832	5,871	5,395
Income before income taxes	2,116	2,251	1,978	2,578
Net income	1,525	1,610	1,430	1,805
Net income per common share, basic	0.43	0.46	0.40	0.52
Net income per common share, diluted	0.43	0.46	0.40	0.52
Dividends per common share	0.20	0.20	0.20	0.22
	2015 Quarter Ended			
	March 31	June 30	September 30	December 31
	(in thousands, except per share amounts)			
Total interest and dividend income	\$5,938	\$6,121	\$ 6,265	\$ 6,169
Net interest income after provision for loan losses	5,408	5,494	6,354	6,117
Noninterest income	1,629	1,644	3,830	1,335
Noninterest expenses	5,058	6,131	5,518	5,774
Income before income taxes	1,979	1,007	4,666	1,678
Net income	1,455	798	3,289	1,355
Net income per common share, basic	0.42	0.23	0.94	0.38
Net income per common share, diluted	0.42	0.23	0.94	0.38
Dividends per common share	0.20	0.20	0.20	0.20

NOTE 22. Fair Value Measurements

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

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

- Level 1 Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement. The following sections provide a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:
Securities Available for Sale: Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

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

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

	Balance as of	Fair Value Measurements at		
		December 2016	December 2015	
		Using Quoted Prices in Active Markets for Identical Assets		
		Other Observable Inputs	Other Observable Inputs	Significant Unobservable Inputs
		(Level 1)	(Level 2)	(Level 3)
		(in thousands)		
Assets:				
Securities available for sale				
Obligations of U.S. government corporations and agencies	\$30,441	\$ —	\$ 30,441	\$ —
Mortgage-backed securities	42,372	—	42,372	—
Obligations of states and political subdivisions	46,449	—	45,835	614
Total assets at fair value	\$119,262	\$ —	\$ 118,648	\$ 614
Liabilities:				
Total liabilities at fair value	\$ —	\$ —	\$ —	\$ —
		Fair Value Measurements at		
		December 31, 2015		
		Using Quoted Prices in Active Markets for Identical Assets		
		Other Observable Inputs	Other Observable Inputs	Significant Unobservable Inputs
		(Level 1)	(Level 2)	(Level 3)
		(in thousands)		
Assets:				
Securities available for sale				
Obligations of U.S. government corporations and agencies	\$37,665	\$ —	\$ 37,665	\$ —
Mortgage-backed securities	28,931	—	28,931	—
Obligations of states and political subdivisions	39,227	—	38,543	684
Total assets at fair value	\$105,823	\$ —	\$ 105,139	\$ 684
Liabilities:				
Interest rate swap	149	—	149	—
Total liabilities at fair value	\$149	\$ —	\$ 149	\$ —

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

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

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

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

The following table displays quantitative information about Level 3 Fair Value Measurements for certain financial assets measured at fair value on a nonrecurring basis for December 31, 2016 and December 31, 2015:

Quantitative information about Level 3 Fair Value Measurements for
December 31, 2016

	Valuation Technique(s)	Unobservable Input	Range	Weighted Average
Assets:				
Impaired loans	Discounted appraised value	Selling cost	12%	12%
Impaired loans	Present value of cash flows	Discount rate	4% - 7%	5%
Other real estate owned	Discounted appraised value	Selling cost	6%	6%

Quantitative information about Level 3 Fair Value Measurements for
December 31, 2015

	Valuation Technique(s)	Unobservable Input	Range	Weighted Average
Assets:				
Impaired loans	Discounted appraised value	Selling cost	12%	12%
Impaired loans	Present value of cash flows	Discount rate	3% - 8%	5%
Other real estate owned	Discounted appraised value	Selling cost	2% - 6%	5%

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

	Carrying value at December 31, 2016		
	Balance as of December 31, 2016 (in thousands)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Financial Assets:			
Impaired loans	\$2,671	\$—	—\$ 2,671
Nonfinancial Assets:			
Other real estate owned	370	—	370
	Carrying value at December 31, 2015		
	Balance as of December 31, 2015 (in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)
Financial Assets:			
Impaired loans	\$5,099	\$—	—\$ 5,099
Nonfinancial Assets:			
Other real estate owned	571	—	571

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

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

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

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

The discount rate was equal to the current interest rate on similar products.

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

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

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

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

	Fair Value Measurements at December 31, 2016 Using				
	Carrying Value as of December 31, 2016 (in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value as of December 31, 2016
Financial Assets:					
Cash and short-term investments	\$35,281	\$ 35,281	\$ —	\$ —	—\$ 35,281
Securities	119,262	—	118,648	614	119,262
Restricted Investments	1,068	—	1,068	—	1,068
Loans, net	512,437	—	—	512,181	512,181
Bank owned life insurance	588	—	588	—	588
Accrued interest receivable	1,769	—	1,769	—	1,769

Financial Liabilities:

Deposits	\$603,877	\$ —	\$ 603,516	\$ —	—\$ 603,516
Accrued interest payable	34	—	34	—	34

Fair Value Measurements at
December 31, 2015
Using

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

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

NOTE 23. Change in Accumulated Other Comprehensive Income (Loss)

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

Changes to accumulated other comprehensive income (loss) by components are shown in the following tables for the years ended December 31, 2016, 2015, and 2014:

	Twelve Months Ended December 31, 2016			2015			2014				
	Unrealized Gains and Losses on Available for Sale Securities	Change in Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total
	(dollars in thousands)										
January 1	\$1,012	\$ 39	\$1,051	\$1,466	\$(190)	\$ 39	\$1,315	\$547	\$(286)	\$ 44	\$305
Other comprehensive (loss) income before reclassifications	(1,531)	—	(1,531)	(564)	52	—	(512)	2,382	145	(8)	2,519
Reclassifications from other comprehensive (loss) income	(98)	—	(98)	(124)	237	—	113	(990)	—	—	(990)
Tax effect of current period changes	554	—	554	234	(99)	—	135	(473)	(49)	3	(519)
Current period changes net of taxes	(1,075)	—	(1,075)	(454)	190	—	(264)	919	96	(5)	1,010
December 31	\$(63)	\$ 39	\$(24)	\$1,012	\$—	\$ 39	\$1,051	\$1,466	\$(190)	\$ 39	\$1,315

For the years ended December 31, 2016, 2015, and 2014, \$98 thousand, \$124 thousand, and \$990 thousand, respectively, was reclassified out of comprehensive income and appeared as Gain on Sale of Securities in the Consolidated Statement of Income. The tax related to these reclassifications was \$33 thousand, \$42 thousand, and \$337 thousand for the years ended December 31, 2016, 2015, and 2014, respectively. The tax is included in Income Tax Expense in the Consolidated Statements of Income.

For the twelve months ended December 31, 2015, \$237 thousand was reclassified out of accumulated other comprehensive income related to the Company's derecognition of its cash flow hedge. This loss was recorded in Other operating income in the Consolidated Statements of Income. Tax related to this reclassification was \$81 thousand and was included in Income Tax Expense in the Consolidated Statements of Income. There were no reclassifications related to cash flow hedges during the twelve months ended December 31, 2016 and 2014.

NOTE 24. Condensed Financial Information – Parent Company Only

EAGLE FINANCIAL SERVICES , INC.

(Parent Company Only)

Balance Sheets

December 31, 2016 and 2015

(dollars in thousands)

	2016	2015
Assets		
Cash held in subsidiary bank	\$391	\$404
Due from banks	—	505
Loans, net of allowance	2,881	2,941
Investment in subsidiaries, at cost, plus undistributed net income	76,099	75,084
Other assets	45	4
Total assets	\$79,416	\$78,938
Liabilities and Shareholders' Equity		
Other liabilities	\$—	\$717
Total liabilities	\$—	\$717
Shareholders' Equity		
Preferred stock	\$—	\$—
Common stock	8,633	8,758
Surplus	12,642	13,730
Retained earnings	58,165	54,682
Accumulated other comprehensive (loss) income	(24)	1,051
Total shareholders' equity	\$79,416	\$78,221
Total liabilities and shareholders' equity	\$79,416	\$78,938

EAGLE FINANCIAL SERVICES , INC.
(Parent Company Only)
Statements of Income
Years Ended December 31, 2016, 2015, and 2014
(dollars in thousands)

	2016	2015	2014
Income			
Dividends from subsidiary bank	\$4,350	\$6,576	\$1,550
Interest and fees on loans	97	52	—
Other interest and dividends	2	11	183
Gain on redemption of trust preferred debt	—	2,424	—
Other income (loss)	149	(121)	283
Total income	\$4,598	\$8,942	\$2,016
Expenses			
Interest expense on borrowings	\$143	\$260	\$317
Other operating expenses	211	260	226
Total expenses	\$354	\$520	\$543
Income before income tax (benefit) expense and equity (deficit) in undistributed earnings of subsidiary bank	\$4,244	\$8,422	\$1,473
Income Tax (Benefit) Expense	(36)	629	(37)
Income before equity (deficit) in undistributed earnings of subsidiary bank	\$4,280	\$7,793	\$1,510
Equity (Deficit) in Undistributed Net Income of Subsidiary Bank	2,090	(896)	5,630
Net income	\$6,370	\$6,897	\$7,140
Comprehensive income	\$5,295	\$6,633	\$8,150

EAGLE FINANCIAL SERVICES , INC.
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2016, 2015, and 2014
(dollars in thousands)

	2016	2015	2014
Cash Flows from Operating Activities			
Net Income	\$6,370	\$6,897	\$7,140
Adjustments to reconcile net income to net cash provided by operating activities			
(Recovery of) Provision for loan losses	(2)	23	—
(Gain) on the sale of securities	—	(27)	(283)
(Gain) on the redemption of trust preferred capital notes	—	(2,424)	—
Loss on derecognition of cash flow hedge	—	237	—
Fair value adjustment on derivative contract	(149)	(88)	—
Stock-based compensation expense	314	328	290
Undistributed earnings of subsidiary bank	(2,090)	896	(5,630)
Changes in assets and liabilities:			
(Increase) decrease in other assets	(39)	294	(10)
(Decrease) increase in other liabilities	(568)	814	1
Net cash provided by operating activities	\$3,836	\$6,950	\$1,508
Cash Flows from Investing Activities			
Purchases of securities available for sale	\$—	\$—	\$(761)
Proceeds from the sale of securities available for sale	—	1,009	1,865
Proceeds from maturities of securities available for sale	—	385	405
Net decrease (increase) in loans	62	(2,963)	—
Net cash provided by (used in) investing activities	\$62	\$(1,569)	\$1,509
Cash Flows from Financing Activities			
Redemption of trust preferred capital notes	\$—	\$(4,793)	\$—
Cash dividends paid	(2,354)	(2,064)	(1,944)
Issuance of common stock, employee benefit plan	81	187	202
Retirement of common stock	(2,143)	—	—
Net cash (used in) financing activities	\$(4,416)	\$(6,670)	\$(1,742)
(Decrease) increase in cash	\$(518)	\$(1,289)	\$1,275
Cash			
Beginning	\$909	\$2,198	\$923
Ending	\$391	\$909	\$2,198

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

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of December 31, 2016 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

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

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

Under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2016, using the 2013 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded as of December 31, 2016, the Company's internal control over financial reporting is adequate and effective and meets the criteria of the Internal Control – Integrated Framework. Management's assessment did not determine any material weaknesses within the Company's internal control structure. There were no changes in the Company's internal control over financial reporting during the Company's quarter ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

Item 9B. Other Information

None.

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PART III

Item 10. Directors, Executives Officers and Corporate Governance

The information required by Part III, Item 10. is incorporated herein by reference to the Proxy Statement for the 2017 Annual Meeting of Shareholders to be held May 16, 2017.

Item 11. Executive Compensation

The information required by Part III, Item 11. is incorporated herein by reference to the Proxy Statement for the 2017 Annual Meeting of Shareholders to be held May 16, 2017.

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

The information required by Part III, Item 12. is incorporated herein by reference to the Proxy Statement for the 2017 Annual Meeting of Shareholders to be held May 16, 2017.

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

The information required by Part III, Item 13. is incorporated herein by reference to the Proxy Statement for the 2017 Annual Meeting of Shareholders to be held May 16, 2017.

Item 14. Principal Accounting Fees and Services

The information required by Part III, Item 14. is incorporated herein by reference to the Proxy Statement for the 2017 Annual Meeting of Shareholders to be held May 16, 2017.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) Financial Statements

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

(a)(2) Financial Statement Schedules

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

(a)(3) Exhibits

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

Exhibit No.	Description
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- | | |
|-----|---|
| 3.1 | Articles of Incorporation of the Company, restated in electronic format only as of March 1, 2006 (incorporated herein by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K dated March 1, 2006). |
| 3.2 | Bylaws of the Company (incorporated herein by reference to Exhibit 3.2 of the Company's Registration Statement on Form S-4, Registration No. 33-43681). |

- 10.1 Description of Executive Supplemental Income Plan (incorporated by reference to Exhibit 10.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 1996).*
- 10.2 Amended and Restated Employment Agreement of John R. Milleson (incorporated herein by reference to Exhibit 10.2 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
- 10.3 Amended and Restated Employment Agreement of James W. McCarty, Jr. (incorporated herein by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
- 10.4 Eagle Financial Services, Inc. Stock Incentive Plan (incorporated herein by reference to Exhibit 4.3 of the Company's Registration Statement on Form S-8, Registration No. 333-118319).*
- 10.5 Eagle Financial Services, Inc. 2014 Stock Incentive Plan, incorporated by reference to Exhibit A of the Proxy Statement for the Annual Meeting of Shareholders held on May 21, 2014, filed in April 21, 2014.
- 10.6 Employment Agreement of John E. Hudson (incorporated herein by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2016).*
- 10.7 Amended and Restated Employment Agreement of Kaley P. Crosen (incorporated herein by reference to Exhibit 10.7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
- 10.9 Employment Agreement of Kathleen J. Chappell (incorporated herein by reference to Exhibit 10.9 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013).*
- 10.10 Eagle Financial Services, Inc. Dividend Investment Plan (incorporated herein by reference to to the Company's Registration Statement on Form S-3, File No. 333-209460, filed on February 10, 2016).*
- 10.11 Employment Agreement of Carl A. Esterhay (incorporated herein by reference to Exhibit 10.11 of the Company's Annual Report on Form 10-K for the year ended December 31, 2016).*
- 10.12 Employment Agreement of Joseph T. Zmitrovich (incorporated herein by reference to Exhibit 10.12 of the Company's Annual Report on Form 10-K for the year ended December 31, 2016).*
- 21.1 Subsidiary of the Company.
- 23.1 Consent of Yount, Hyde & Barbour, P.C.
- 23.2 Consent of Smith Elliott Kearns & Company, LLC.
- 31.1 Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 32.1 Certification by Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

The following materials from the Eagle Financial Service, Inc. Annual Report on Form 10-K for the year ended December 31, 2016 formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) notes to Consolidated Financial Statements.

*Management contracts and compensatory plans and arrangements.

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

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

SIGNATURES

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

Eagle Financial Services, Inc.

By: /s/ JOHN R. MILLESON

John R. Milleson

President and Chief Executive Officer

Date: March 29, 2017

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 29, 2017.

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

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