EAGLE FINANCIAL SERVICES INC
Form 10-Q
August 14, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2017
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 0-20146
EAGLE FINANCIAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

Virginia	54-1601306
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2 East Main Street P.O. Box 391 Berryville, Virginia	22611
(Address of principal executive offices)	(Zip Code)

(540) 955-2510
(Registrant’s telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date 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 ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨(Do not check if a smaller reporting company.)	Smaller reporting company	ý
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

The number of shares of the registrant's Common Stock ($2.50 par value) outstanding as of August 3, 2017 was 3,474,659.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

EAGLE FINANCIAL SERVICES, INC.
Consolidated Balance Sheets
(dollars in thousands, except per share amounts)

	June 30, 2017 (Unaudited)	December 31, 2016
Assets		
Cash and due from banks	$ 9,562	$ 12,515
Interest-bearing deposits with other institutions	17,622	22,610
Federal funds sold	152	156
Total cash and cash equivalents	27,336	35,281
Securities available for sale, at fair value	131,655	119,262
Restricted investments	1,957	1,068
Loans	554,179	516,942
Allowance for loan losses	(4,407)	(4,505)
Net Loans	549,772	512,437
Bank premises and equipment, net	19,911	20,169
Other real estate owned, net of allowance	106	370
Other assets	13,312	11,562
Total assets	$ 744,049	$ 700,149
Liabilities and Shareholders’ Equity		
Liabilities		
Deposits:		
Noninterest bearing demand deposits	$ 218,117	$ 208,948
Savings and interest bearing demand deposits	312,990	306,847
Time deposits	100,903	88,082
Total deposits	$ 632,010	$ 603,877
Federal Home Loan Bank advances	20,000	—
Other liabilities	8,871	16,856
Total liabilities	$ 660,881	$ 620,733
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 2017, 3,481,946 including 19,401 shares of unvested restricted stock; issued and outstanding 2016, 3,468,243 including 14,901 shares of unvested restricted stock	8,656	8,633
Surplus	12,748	12,642
Retained earnings	60,705	58,165
Accumulated other comprehensive income (loss)	1,059	(24)
Total shareholders’ equity	$ 83,168	$ 79,416
Total liabilities and shareholders’ equity	$ 744,049	$ 700,149

See Notes to Consolidated Financial Statements

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EAGLE FINANCIAL SERVICES, INC.
Consolidated Statements of Income (Unaudited)
(dollars in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Interest and Dividend Income				
Interest and fees on loans	$6,108	$5,883	$11,844	$11,592
Interest and dividends on securities available for sale:				
Taxable interest income	591	482	1,141	922
Interest income exempt from federal income taxes	270	232	524	465
Dividends	19	23	24	46
Interest on deposits with other institutions	16	22	37	38
Total interest and dividend income	$7,004	$6,642	$13,570	$13,063
Interest Expense				
Interest on deposits	218	194	$421	$395
Interest on federal funds purchased	13	—	13	—
Interest on Federal Home Loan Bank advances	18	64	18	129
Interest on interest rate swap	—	39	—	80
Total interest expense	$249	$297	$452	$604
Net interest income	$6,755	$6,345	$13,118	$12,459
(Recovery of) Provision For Loan Losses	(230)	—	(757)	79
Net interest income after (recovery of) provision for loan losses	$6,985	$6,345	$13,875	$12,380
Noninterest Income				
Income from fiduciary activities	$309	$380	$601	$708
Service charges on deposit accounts	295	290	594	580
Other service charges and fees	957	992	1,910	1,821
Gain on sale of securities	1	—	51	86
Other operating income	36	76	115	178
Total noninterest income	$1,598	$1,738	$3,271	$3,373
Noninterest Expenses				
Salaries and employee benefits	$3,364	$3,313	$6,714	$6,577
Occupancy expenses	367	367	744	775
Equipment expenses	259	223	498	469
Advertising and marketing expenses	175	185	353	347
Stationery and supplies	47	51	88	101
ATM network fees	183	259	403	436
Other real estate owned expense	10	2	11	2
Loss (gain) on valuation adjustments and sales of other real estate owned	—	47	(1)	47
FDIC assessment	55	99	107	204
Computer software expense	159	131	355	267
Bank franchise tax	134	125	259	251
Professional fees	267	281	558	509
Data processing fees	139	132	256	196
Other operating expenses	588	617	1,113	1,205
Total noninterest expenses	$5,747	$5,832	$11,458	$11,386
Income before income taxes	$2,836	$2,251	$5,688	$4,367

Income Tax Expense	809	641	1,619	1,232
Net income	$2,027	$1,610	$4,069	$3,135
Earnings Per Share				
Net income per common share, basic	$0.58	$0.46	$1.17	$0.89
Net income per common share, diluted	$0.58	$0.46	$1.17	$0.89

See Notes to Consolidated Financial Statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income	$2,027	$1,610	$4,069	$3,135
Other comprehensive income:				
Unrealized gain on available for sale securities net of reclassification adjustments, and net of deferred income tax of $595 and $222 for the three months ended, respectively and $558 and $511 for the six months ended, respectively	1,154	430	1,083	993
Total other comprehensive income	1,154	430	1,083	993
Total comprehensive income	$3,181	$2,040	$5,152	$4,128

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC.
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
(dollars in thousands, except share amounts)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2015	$ 8,758	$ 13,730	$ 54,682	$ 1,051	$ 78,221
Net income			3,135		3,135
Other comprehensive income				993	993
Vesting of restricted stock awards, stock incentive plan (8,196 shares)	20	(20)			—
Stock-based compensation expense		107			107
Issuance of common stock, dividend investment plan (14,810 shares)	37	298			335
Issuance of common stock, employee benefit plan (648 shares)	2	14			16
Dividends declared ($0.40 per share)			(1,412)		(1,412)
Balance, June 30, 2016	$ 8,817	$ 14,129	$ 56,405	$ 2,044	$ 81,395
Balance, December 31, 2016	$ 8,633	$ 12,642	$ 58,165	$ (24)	79,416
Net income			4,069		4,069
Other comprehensive income				1,083	1,083
Vesting of restricted stock awards, stock incentive plan (9,493 shares)	24	(24)			—
Stock-based compensation expense		138			138
Issuance of common stock, dividend investment plan (8,887 shares)	22	232			254
Issuance of common stock, employee benefit plan (4,874 shares)	12	124			136
Repurchase and retirement of common stock (14,051 shares)	(35)	(364)			(399)
Dividends declared ($0.44 per share)			(1,529)		(1,529)
Balance, June 30, 2017	$ 8,656	$ 12,748	$ 60,705	$ 1,059	$ 83,168

See Notes to Consolidated Financial Statements

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

	Six Months Ended June 30, 2017	2016
Cash Flows from Operating Activities		
Net income	$4,069	$3,135
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation	474	464
Amortization of intangible and other assets	106	86
(Recovery of) Provision for loan losses	(757)	79
(Gain) loss on valuation adjustments and sales of other real estate owned	(1)	47
Loss on the sale and disposal of premises and equipment	11	—
Loss on the sale of repossessed assets	6	—
(Gain) on the sale of securities	(51)	(86)
Fair value adjustment on derivative contract	—	(71)
Stock-based compensation expense	138	107
Premium amortization on securities, net	246	115
Changes in assets and liabilities:		
(Increase) decrease in other assets	(2,419)	60
(Decrease) increase in other liabilities	(7,985)	502
Net cash (used in) provided by operating activities	$(6,163)	$4,438
Cash Flows from Investing Activities		
Proceeds from maturities, calls, and principal payments of securities available for sale	$4,781	$12,593
Proceeds from the sale of securities available for sale	4,925	4,314
Purchases of securities available for sale	(20,653)	(12,391)
Purchases of restricted investments	(889)	(22)
Purchases of bank premises and equipment	(227)	(105)
Proceeds from the sale of other real estate owned	318	—
Proceeds from the sale of repossessed assets	3	1
Net (increase) in loans	(36,635)	(21,905)
Net cash (used in) investing activities	$(48,377)	$(17,515)
Cash Flows from Financing Activities		
Net increase in noninterest bearing demand deposits, savings, and interest bearing demand deposits	$15,312	$23,749
Net increase (decrease) in time deposits	12,821	(3,238)
Net increase in Federal Home Loan Bank advances	20,000	—
Issuance of common stock, employee benefit plan	136	16
Repurchase and retirement of common stock	(399)	—
Cash dividends paid	(1,275)	(1,077)
Net cash provided by financing activities	$46,595	$19,450

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

	Six Months Ended June 30,	
	2017	2016
(Decrease) increase in cash and cash equivalents	$(7,945)	$6,373
Cash and Cash Equivalents		
Beginning	35,281	23,221
Ending	$27,336	$29,594
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$452	$612
Income taxes	$598	$—
Supplemental Schedule of Noncash Investing and Financing Activities:		
Unrealized gain on securities available for sale	$1,641	$1,504
Other real estate and repossessed assets acquired in settlement of loans	$57	$6
Issuance of common stock, dividend investment plan	$254	$335

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC.
Notes to Consolidated Financial Statements (Unaudited)
June 30, 2017
NOTE 1. General

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

In the opinion of management, the accompanying financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position at June 30, 2017 and December 31, 2016, the results of operations for the three and six months ended June 30, 2017 and 2016, and cash flows for the six months ended June 30, 2017 and 2016. The results of operations for the three and six months ended June 30, 2017 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016 (the "2016 Form 10-K").

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

Certain amounts in the consolidated financial statements have been reclassified to conform to current year presentations. None of the reclassifications were of a material nature and they had no effect on prior year net income or shareholders' equity.
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NOTE 2. Stock-Based Compensation Plan

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

The Company periodically grants Restricted Stock to its directors and executive officers. Restricted Stock provides grantees with rights to shares of common stock upon completion of a service period or achievement of Company performance measures. During the restriction period, all shares are considered outstanding and dividends are paid to the grantee. In general, outside directors are periodically granted restricted shares which vest over a period of less than 9 months. Beginning during 2006, executive officers were granted restricted shares which vest over a 3 year service period and restricted shares which vest based on meeting annual performance measures over a 1 year period. The Company recognizes compensation expense over the restricted period. As of June 30, 2017, there was $266 thousand of unrecognized compensation cost related to nonvested restricted stock.

The following table presents Restricted Stock activity for the six months ended June 30, 2017 and 2016:

	Six Months Ended June 30,			
	2017		2016	
	Shares	Weighted Average	Shares	Weighted Average

		Grant Date Fair Value		Grant Date Fair Value
Nonvested, beginning of period	14,901	$ 23.05	14,401	$ 22.98
Granted	14,650	27.46	14,650	23.07
Vested	(9,493)	23.08	(8,196)	22.86
Forfeited	(657)	23.00	(954)	23.00
Nonvested, end of period	19,401	26.37	19,901	23.09

NOTE 3. Earnings Per Common Share

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

The following table shows the weighted average number of shares used in computing earnings per share for the three and six months ended June 30, 2017 and 2016. During 2017 and 2016, there were no potentially dilutive securities outstanding.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Weighted average number of common shares outstanding used to calculate basic and diluted earnings per share	3,474,628	3,539,876	3,476,159	3,535,505

NOTE 4. Securities

Amortized costs and fair values of securities available for sale at June 30, 2017 and December 31, 2016 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
	June 30, 2017 (in thousands)			
Obligations of U.S. government corporations and agencies	$30,419	$ 460	$ (135)	$30,744
Mortgage-backed securities	50,579	344	(223)	50,700
Obligations of states and political subdivisions	49,110	1,224	(123)	50,211
	$130,108	$ 2,028	$ (481)	$131,655
	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

During the six months ended June 30, 2017, the Company received proceeds of $4.9 million on sales of available for sale securities for a gross gain of $51 thousand. There were no losses on the sale of available for sale securities during the six months ended June 30, 2017. During the six months ended June 30, 2016, the Company sold $4.3 million of available for sale securities for a gross gain of $86 thousand. There were no losses on the sale of available for sale securities during the six months ended June 30, 2016.

The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at June 30, 2017 and December 31, 2016 were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	June 30, 2017 (in thousands)					
Obligations of U.S. government corporations and agencies	$7,879	$ 135	$ —	$ —	$7,879	$ 135
Mortgage-backed securities	21,203	223	—	—	21,203	223
Obligations of states and political subdivisions	5,758	123	—	—	5,758	123
	$34,840	$ 481	$ —	$ —	$34,840	$ 481
	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

Gross unrealized losses on available for sale securities included thirty-seven (37) and eighty (80) debt securities at June 30, 2017 and December 31, 2016, respectively. The Company evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the amount of an unrealized loss, the financial condition of the issuer, and the intent and ability of the Company to retain its investment in the issuer long enough to allow for an anticipated recovery in fair value. The fair value of a security reflects its liquidity as compared to similar instruments, current market rates on similar instruments, and the creditworthiness of the issuer. Absent any change in the liquidity of a security or the creditworthiness of the issuer, prices will decline as market rates rise and vice-versa. The primary cause of the unrealized losses at June 30, 2017 and December 31, 2016 was changes in market interest rates. Since the losses can be primarily attributed to changes in market interest rates and not expected cash flows or an issuer's financial condition, the unrealized losses were deemed to be temporary. The Company's mortgage-backed securities are issued by U.S. government agencies, which guarantee payments to investors regardless of the status of the underlying mortgages. The Company monitors the financial condition of these issuers continuously and will record other-than-temporary impairment if the recovery of value is unlikely.

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

Securities having a carrying value of $2.9 million at June 30, 2017 were pledged for various purposes required by law.

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The composition of restricted investments at June 30, 2017 and December 31, 2016 was as follows:

	June 30, 2017	December 31, 2016
	(in thousands)	
Federal Reserve Bank Stock	$344	$ 344
Federal Home Loan Bank Stock	1,473	584
Community Bankers' Bank Stock	140	140
	$1,957	$ 1,068

NOTE 5. Allowance for Loan Losses

Changes in the allowance for loan losses for the six months ended June 30, 2017 and 2016 and the year ended December 31, 2016 were as follows:

	Six Months Ended June 30, 2017	Year Ended December 31, 2016	Six Months Ended June 30, 2016
		(in thousands)	
Balance, beginning	$4,505	$ 4,959	$4,959
(Recovery of) provision for loan losses	(757)	(188)	79
Recoveries added to the allowance	799	341	90
Loan losses charged to the allowance	(140)	(607)	(155)
Balance, ending	$4,407	$ 4,505	$4,973

Nonaccrual and past due loans by class at June 30, 2017 and December 31, 2016 were as follows:

	June 30, 2017 (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	$—	$ —	$ —	$ —	$35,678	$ 35,678	$ —	$ 237
Commercial Real Estate:								
Owner Occupied	415	—	—	415	125,014	125,429	—	415
Non-owner occupied	49	—	—	49	112,968	113,017	—	183
Construction and Farmland:								
Residential	—	—	—	—	3,519	3,519	—	—
Commercial	—	—	—	—	32,259	32,259	—	—
Consumer:								
Installment	28	2	6	36	12,507	12,543	—	16
Residential:								
Equity Lines	67	—	—	67	32,409	32,476	—	108
Single family	699	197	4,283	5,179	187,896	193,075	—	4,642

Multifamily	—	—	—	—	4,367	4,367	—	—
All Other Loans	—	—	—	—	1,816	1,816	—	—
Total	$1,258	$ 199	$ 4,289	$ 5,746	$548,433	$ 554,179	$ —	$ 5,601

	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 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

Allowance for loan losses by segment at June 30, 2017 and December 31, 2016 were as follows:

	As of and For the Six Months Ended June 30, 2017 (in thousands)							
	Construction and Farmland	Residential	Commercial Real Estate	Commercial - Non Real Estate	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	$450	$1,992	$1,522	$235	$69	$22	$ 215	$4,505
Charge-Offs	—	(33)	—	(58)	(24)	(25)	—	(140)
Recoveries	504	163	93	14	23	2	—	799
(Recovery of) provision for loan losses	(547)	(296)	(33)	93	(3)	23	6	(757)
Ending balance	$407	$1,826	$1,582	$284	$65	$22	$ 221	$4,407
Ending balance:								
Individually evaluated for impairment	$—	$205	$64	$2	$—	$—	$ —	$271
Ending balance: collectively evaluated for impairment	$407	$1,621	$1,518	$282	$65	$22	$ 221	$4,136
Loans:								
Ending balance	$35,778	$229,918	$238,446	$35,678	$12,543	$1,816	$ —	$554,179
Ending balance individually evaluated for impairment	$331	$8,571	$1,748	$504	$16	$—	$ —	$11,170
	$35,447	$221,347	$236,698	$35,174	$12,527	$1,816	$ —	$543,009

Ending balance collectively evaluated for impairment

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As of and for the Twelve Months Ended
December 31, 2016
(in thousands)

	Construction and Farmland	Residential	Commercial Real Estate	Commercial - Non Real Estate	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	$775	$2,322	$1,268	$211	$109	$53	$221	$4,959
Charge-Offs	—	(535)	—	—	(30)	(42)	—	(607)
Recoveries	144	124	8	11	49	5	—	341
(Recovery of) provision for loan losses	(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

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Impaired loans by class as of and for the periods ended June 30, 2017 and December 31, 2016 were as follows:

	As of and for the Six Months Ended June 30, 2017 (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	$258	$ 237	$ —	$ 266	$ 7
Commercial Real Estate:					
Owner Occupied	865	750	—	753	7
Non-owner occupied	215	184	—	185	—
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	331	331	—	338	14
Consumer:					
Installment	17	16	—	17	—
Residential:					
Equity lines	236	60	—	62	—
Single family	7,273	7,083	—	7,172	60
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	$9,195	$ 8,661	$ —	$ 8,793	$ 88
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	$267	$ 267	$ 2	$ 276	$ 6
Commercial Real Estate:					
Owner Occupied	—	—	—	—	—
Non-owner occupied	815	817	64	821	18
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	—	—	—	—	—
Residential:					
Equity lines	218	48	48	48	—
Single family	1,400	1,392	157	1,401	31
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	$2,700	$ 2,524	$ 271	$ 2,546	$ 55
Total:					
Commercial	$525	$ 504	$ 2	$ 542	$ 13
Commercial Real Estate	1,895	1,751	64	1,759	25
Construction and Farmland	331	331	—	338	14
Consumer	17	16	—	17	—
Residential	9,127	8,583	205	8,683	91
Other	—	—	—	—	—
Total	$11,895	$ 11,185	$ 271	$ 11,339	$ 143

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

	As of and for the Twelve Months End December 31, 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, net deferred loan fees or costs, and any partial charge-offs.

The average recorded investment for impaired loans for the three months ended June 30, 2017 was $11.3 million. The interest income recognized on impaired loans for the three months ended June 30, 2017 was $75 thousand.

When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is in nonaccrual status, all payments are applied to principal under the cost-recovery method. For financial statement purposes, the recorded investment in nonaccrual loans is the actual principal balance reduced by payments that would otherwise have been applied to interest. When reporting information on these loans to the applicable customers, the unpaid principal balance is reported as if payments were applied to principal and interest under the original terms of the loan agreements. Therefore, the unpaid principal balance reported to the customer would be higher than the recorded investment in the loan for financial statement purposes. When the ultimate collectability of the total principal of the impaired loan is not in doubt and the loan is in nonaccrual status, contractual interest is credited to interest income when received under the cash-basis method.
The Company uses a rating system for evaluating the risks associated with non-consumer loans. Consumer loans are not evaluated for risk unless the characteristics of the loan fall within classified categories. Consumer loans are evaluated for collection based on payment performance. Descriptions of these ratings are as follows:

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

Credit quality information by class at June 30, 2017 and December 31, 2016 was as follows:

As of June 30, 2017 (in thousands)

INTERNAL RISK RATING GRADES	Pass	Pass Monitored	Special Mention	Substandard	Doubtful	Loss	Total
Commercial - Non Real Estate:							
Commercial & Industrial	$31,883	$ 3,435	$ 113	$ 247	$ —	$ —	$35,678
Commercial Real Estate:							
Owner Occupied	109,982	13,675	1,022	335	415	—	125,429
Non-owner occupied	81,629	29,556	1,416	416	—	—	113,017
Construction and Farmland:							
Residential	3,430	89	—	—	—	—	3,519
Commercial	21,976	9,952	—	331	—	—	32,259
Residential:							
Equity Lines	31,917	451	—	—	108	—	32,476
Single family	179,100	6,757	525	6,549	144	—	193,075
Multifamily	4,367	—	—	—	—	—	4,367
All other loans	1,816	—	—	—	—	—	1,816
Total	$466,100	$ 63,915	$ 3,076	$ 7,878	$ 667	$ —	$541,636

	Performing	Nonperforming
Consumer Credit Exposure by Payment Activity	$ 12,507	$ 36

As of December 31, 2016 (in thousands)

INTERNAL RISK RATING GRADES	Pass	Pass Monitored	Special Mention	Substandard	Doubtful	Loss	Total
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 Farm land:							
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

	Performing	Nonperforming
Consumer Credit Exposure by Payment Activity	$ 12,641	$ 36

NOTE 6. Troubled Debt Restructurings

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

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

There were twenty-two (22) troubled debt restructured loans totaling $5.1 million at June 30, 2017. At December 31, 2016, there were twenty-six (26) troubled debt restructured loans totaling $7.3 million. Three loans, totaling $700 thousand, were in nonaccrual status at June 30, 2017. Six loans, totaling $1.6 million, were in nonaccrual status at December 31, 2016. There were no outstanding commitments to lend additional amounts to troubled debt restructured borrowers at June 30, 2017 or December 31, 2016.

During the three and six months ended June 30, 2017, the Company restructured no loans by granting concessions to borrowers experiencing financial difficulties. During the three months ended June 30, 2016, the Company restructured no loans by granting concessions to borrowers experiencing financial difficulties.

The following table and narrative set forth information on the Company's troubled debt restructurings by class of financing receivable occurring during the six months ended June 30, 2016:

		Six Months Ended June 30, 2016 (in thousands)	
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial Real Estate:			
Non-owner Occupied	1	$ 736	$ 736
Residential:			
Single family	1	96	96
Total	2	$ 832	$ 832

During the six months ended June 30, 2016, the Company restructured two 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.

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 period were:

	Three Months Ended June 30, 2017 (in thousands)	
	Number of Contracts	Recorded Investment
Residential:		
Single family	1	$ 236
Total	1	$ 236

	Three Months Ended June 30, 2016 (in thousands)	
	Number of Contracts	Recorded Investment
Total	—	$ —

	Six Months Ended June 30, 2017 (dollars in thousands)	
	Number of Contracts	Recorded Investment
Residential:		
Single family	1	$ 236
Total	1	$ 236

	Six Months Ended June 30, 2016 (dollars in thousands)	
	Number of Contracts	Recorded Investment
Residential:		
Single family	1	$ 107
Total	1	$ 107

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

NOTE 7. Deposits

The composition of deposits at June 30, 2017 and December 31, 2016 was as follows:

	June 30, 2017	December 31, 2016
	(in thousands)	
Noninterest bearing demand deposits	$218,117	$208,948
Savings and interest bearing demand deposits:		
NOW accounts	$83,426	$85,944
Money market accounts	128,123	126,632
Regular savings accounts	101,441	94,271
	$312,990	$306,847
Time deposits:		
Balances of less than $250,000	$65,283	$67,159
Balances of $250,000 and more	35,620	20,923
	$100,903	$88,082
	$632,010	$603,877

NOTE 8. Postretirement Benefit Plans

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

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

Net periodic benefit costs of the postretirement benefit plan for the three months ended June 30, 2017 and 2016 were $(1) thousand and zero, respectively. Net periodic benefit costs of the postretirement benefit plan for the six months ended June 30, 2017 and 2016 were $(2) thousand and $(1) thousand, respectively.

NOTE 9. 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.

The following table presents balances of financial assets and liabilities measured at fair value on a recurring basis at June 30, 2017 and December 31, 2016:

		Fair Value Measurements at June 30, 2017 Using		
	Balance as of June 30, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Assets:				
Securities available for sale				
Obligations of U.S. government corporations and agencies	$30,744	$ —	$ 30,744	$ —
Mortgage-backed securities	50,700	—	50,700	—
Obligations of states and political subdivisions	50,211	—	49,632	579
Total assets at fair value	$131,655	$ —	$ 131,076	$ 579

		Fair Value Measurements at December 31, 2016 Using		
	Balance as of December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (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

The table below presents a reconciliation for all assets measured and recognized at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2017 and 2016.

Level 3 Recurring
Fair Value Measurements

	As of and For the Three Months Ended		As of and For the Six Months Ended	
	June 30, 2017	June 30, 2016	June 30, 2017	June 30, 2016
	(in thousands)		(in thousands)	
Beginning balance	$587	$ 657	$614	$ 684
Purchases	—	—	—	—
Sales	—	—	—	—
Issuances	—	—	—	—
Settlements	(8)	(8)	(35)	(35)
Total assets at fair value	$579	$ 649	$579	$ 649

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

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

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

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

The following table displays quantitative information about Level 3 Fair Value Measurements for certain financial assets measured at fair value on a nonrecurring basis at June 30, 2017 and December 31, 2016:

	Quantitative information about Level 3 Fair Value Measurements for June 30, 2017			
	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% - 6%	5%
Other real estate owned	Discounted appraised value	Selling cost	4%	4%

	December 31, 2016			
	Valuation Technique(s)	Unobservable Input	Range	Weighted Average

Impaired loans	Discounted appraised value	Selling cost	12%	12%
Impaired loans	Present value of cash flows	Discount rate	4% - 7%	5%
Other real estate owned	Discounted appraised value	Selling cost	6%	6%

The following table summarizes the Company's financial and nonfinancial assets that were measured at fair value on a nonrecurring basis at June 30, 2017 and December 31, 2016:

	Balance as of June 30, 2017	Fair Value at June 30, 2017 Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Financial Assets:				
Impaired loans	$2,245	$ —	$ —	$ 2,245
Nonfinancial Assets:				
Other real estate owned	106	—	—	106

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

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

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

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

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

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

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

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

The carrying value and fair value of the Company's financial instruments at June 30, 2017 and December 31, 2016 were as follows:

	Fair Value Measurements at June 30, 2017 Using				
	Carrying Value as of	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value as of
	June 30, 2017	(Level 1)	(Level 2)	(Level 3)	June 30, 2017
	(in thousands)				
Financial Assets:					
Cash and short-term investments	$27,336	$ 27,336	$—	$ —	$27,336
Securities	131,655	—	131,076	579	131,655
Restricted Investments	1,957	—	1,957	—	1,957
Loans, net	549,772	—	—	547,903	547,903
Bank owned life insurance	588	—	588	—	588
Accrued interest receivable	1,756	—	1,756	—	1,756
Financial Liabilities:					
Deposits	$632,010	$ —	$ 631,445	$ —	$631,445
Federal Home Loan Bank advances	20,000	—	19,999	—	19,999
Accrued interest payable	34	—	34	—	34

	Fair Value Measurements at December 31, 2016 Using				
	Carrying Value as of	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value as of
	December 31, 2016	(Level 1)	(Level 2)	(Level 3)	December 31, 2016
	(in thousands)				
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

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 10. Derivative Instruments and Hedging Activities

Interest Rate Swaps

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

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

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

On December 4, 2008, the Company entered into an interest rate swap agreement related to the outstanding trust preferred capital notes. The swap agreement became effective on December 1, 2008. The notional amount of the interest rate swap was $7.0 million and 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 balance of the interest rate swap liability was $237 thousand at the time of the redemption of the Company's trust preferred debt on July 29, 2015. The total amount recorded in accumulated other comprehensive income at that date was reclassified to earnings due to the derecognition of the cash flow hedge.

The following tables present the effect of the derivative instrument on the Consolidated Statements of Income for the three and six months ended June 30, 2017 and 2016:

	Three Months Ended June 30,		
Derivatives not designated as hedging instruments under GAAP	Location of Gain (Loss) Recognized in Income	Amount of Gain (Loss) Recognized in Income	
		2017	2016
		(dollars in thousands)	
Interest rate swap contracts	Other operating income	$ —	$ 38

	Six Months Ended June 30,		
Derivatives not designated as hedging instruments under GAAP	Location of Gain (Loss) Recognized in Income	Amount of Gain (Loss) Recognized in Income	
		2017	2016
		(dollars in thousands)	
Interest rate swap contracts	Other operating income	$ —	$ 71

NOTE 11. Change in Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) includes unrealized gains and losses on available for sale securities 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 their 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 component are shown in the following tables for the periods indicated:

	Three Months Ended June 30,					
	2017			2016		
	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 Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total
	(dollars in thousands)					
April 1	$(134)	$ 39	$(95)	$1,575	$ 39	$1,614
Other comprehensive income before reclassifications	1,750	—	1,750	652	—	652
Reclassification adjustments	(1)	—	(1)	—	—	—
Tax effect of current period changes	(595)	—	(595)	(222)	—	(222)
Current period changes net of taxes	1,154	—	1,154	430	—	430
June 30	$1,020	$ 39	$1,059	$2,005	$ 39	$2,044

	Six Months Ended June 30, 2017			2016		
	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 Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total
	(dollars in thousands)					
January 1	$(63)	$ 39	$(24)	$1,012	$ 39	$1,051
Other comprehensive income before reclassifications	1,692	—	1,692	1,590	—	1,590
Reclassification adjustments	(51)	—	(51)	(86)	—	(86)
Tax effect of current period changes	(558)	—	(558)	(511)	—	(511)
Current period changes net of taxes	1,083	—	1,083	993	—	993
June 30	$1,020	$ 39	$1,059	$2,005	$ 39	$2,044

For the three and six months ended June 30, 2017, $1 thousand and $51 thousand, respectively was reclassified out of accumulated other comprehensive income (loss) and appeared as Gain on sale of securities in the Consolidated Statements of Income. The tax related to this reclassification was zero and $17 thousand for the three and six months ended June 30, 2017, respectively. For the three and six months ended June 30, 2016, zero and $86 thousand, respectively was reclassified out of comprehensive income (loss) and appeared as Gain on sale of securities in the Consolidated Statements of Income. The tax related to this reclassification was zero and $29 thousand for the three and six months ended June 30, 2016. The tax is included in Income Tax Expense in the Consolidated Statements of Income.

NOTE 12. Other Real Estate Owned

The following table is a summary of other real estate owned (OREO) activity for the six months ended June 30, 2017 and 2016 and the year ended December 31, 2016:

	Six Months Ended June 30, 2017	Year Ended December 31, 2016	Six Months Ended June 30, 2016
	(in thousands)		
Balance, beginning	$370	$ 571	$ 571
Net loans transferred to OREO	53	666	—
Sales	(317)	(890)	—
Valuation adjustments	—	23	(47)
Balance, ending	$106	$ 370	$ 524

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The major classifications of other real estate owned in the consolidated balance sheets at June 30, 2017 and December 31, 2016 were as follows:

	As of June 30, 2017	December 31, 2016
	(in thousands)	
Construction and Farmland	$106	$ 155
Residential Real Estate	—	215
Commercial Real Estate	—	—
Subtotal	$106	$ 370
Less valuation allowance	—	—
Total	$106	$ 370

There were no consumer mortgage loans collateralized by residential real estate in the process of foreclosure at June 30, 2017 or December 31, 2016.

NOTE 13. Qualified Affordable Housing Project Investments

The Company invests in qualified affordable housing projects. The general purpose of these investments is to encourage and assist participants in investing in low-income residential rental properties located in the Commonwealth of Virginia, develop and implement strategies to maintain projects as low-income housing, provide tax credits and other tax benefits to investors, and to preserve and protect project assets.

At June 30, 2017 and December 31, 2016, the balance of the investment for qualified affordable housing projects was $2.5 million and $2.6 million, respectively. These balances are reflected in Other assets on the Consolidated Balance Sheets. Total unfunded commitments related to the investments in qualified affordable housing projects totaled $2.0 million at June 30, 2017 and December 31, 2016. These balances are reflected in Other liabilities on the Consolidated Balance Sheets. The Company expects to fulfill these commitments by December 31, 2020, in accordance with the terms of the individual agreements.

During the three months ended June 30, 2017 and 2016, the Company recognized amortization expense of $43 thousand and $28 thousand, respectively. During the six months ended June 30, 2017 and 2016, the Company recognized amortization expense of $86 thousand and $57 thousand, respectively. The amortization expense was included in Other operating expenses on the Consolidated Statements of Income.

Total estimated credits to be received during 2017 are $232 thousand based on the most recent quarterly estimates received from the funds. Total tax credits and other tax benefits recognized during the three months ended June 30, 2017 and 2016, were $58 thousand and $33 thousand, respectively. Total tax credits and other tax benefits recognized during the six months ended June 30, 2017 and 2016, were $116 thousand and $66 thousand, respectively.

NOTE 14. Recent Accounting Pronouncements

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2)

Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842).” Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee‘s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.
During June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

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

During 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.

During 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.

During March 2017, the FASB issued ASU 2017-07, "Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." The amendments in this ASU require an employer that offers defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715 to report the service cost component of net periodic benefit cost in the same line item(s) as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented in the income statement separately from the service cost component. If the other components of net periodic benefit cost are not presented on a separate line or lines, the line item(s) used in the income statement must be disclosed. In addition, only the service cost component will be eligible for capitalization as part of an asset, when applicable. The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted. The Company does not expect the adoption of ASU 2017-07 to have a material impact on its consolidated financial statements.

During March 2017, the FASB issued ASU 2017 08, "Receivables-Nonrefundable Fees and Other Costs (Subtopic 310 20), Premium Amortization on Purchased Callable Debt Securities." The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company is currently assessing the impact that ASU 2017 08 will have on its consolidated financial statements.

During May 2017, the FASB issued ASU 2017 09, "Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting." The amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The amendments are effective for all entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. The Company is currently assessing the impact that ASU 2017 09 will have on its consolidated financial statements.

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

The purpose of this discussion is to focus on the important factors affecting the Company's financial condition, results of operations, liquidity and capital resources. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and the Notes to the Consolidated Financial Statements presented in Part I, Item 1, Financial Statements, of this Form 10-Q and Item 8, Financial Statements and Supplementary Data, of the 2016 Form 10-K.

GENERAL

Eagle Financial Services, Inc. is a bank holding company which owns 100% of the stock of Bank of Clarke County (the "Bank" and collectively with Eagle Financial Services, Inc., the "Company"). Accordingly, the results of operations for the Company are dependent upon the operations of the Bank. The Bank conducts commercial banking business which consists of attracting deposits from the general public and investing those funds in commercial, consumer and real estate loans and municipal and U.S. government agency securities. The Bank's deposits are insured by the Federal Deposit Insurance Corporation to the extent permitted by law. At June 30, 2017, the Company had total assets of $744.0 million, net loans of $549.8 million, total deposits of $632.0 million, and shareholders' equity of $83.2 million. The Company's net income was $4.1 million for the six months ended June 30, 2017.

MANAGEMENT’S STRATEGY

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

OPERATING STRATEGY

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

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

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

LENDING POLICIES

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

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

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

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

One-to-Four-Family Residential Real Estate Lending

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

Commercial Real Estate Lending

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

Construction and Land Development Lending

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

Commercial and Industrial Lending

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

Consumer Lending

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

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

CRITICAL ACCOUNTING POLICIES

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

- the ability to successfully manage growth or implement growth strategies if the Bank is unable to identify attractive markets, locations or opportunities to expand in the future or if the Bank is unable to successfully integrate new branches and other growth opportunities into its existing operations;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- the successful management of interest rate risk;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- changes in general economic and business conditions in the market area;
- reliance on the management team, including the ability to attract and retain key personnel;
- changes in interest rates and interest rate policies;
- maintaining capital levels adequate to support growth;
- maintaining cost controls and asset qualities as new branches are opened or acquired;
- demand, development and acceptance of new products and services;
- problems with technology utilized by the Bank;
- changing trends in customer profiles and behavior;
- changes in banking and other laws and regulations; and
- other factors described in Item 1A., “Risk Factors,” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

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

RESULTS OF OPERATIONS

Net Income

Net income for the six months ended June 30, 2017 was $4.1 million, an increase of $934 thousand or 29.79% as compared to net income for the six months ended June 30, 2016 of $3.1 million. Earnings per share, basic and diluted, were $1.17 and $0.89 for the six months ended June 30, 2017 and 2016, respectively. Net income during the second quarter of 2017 was $2.0 million, an increase of $417 thousand or 25.90% as compared to net income during the second quarter of 2016 of $1.6 million. Earnings per share, basic and diluted were $0.58 and $0.46 for the second quarter of 2017 and the second quarter of 2016, respectively.

Return on average assets (ROA) measures how efficiently the Company uses its assets to produce net income. Some issues reflected within this efficiency include the Company’s asset mix, funding sources, pricing, fee generation, and cost control. The ROA of the Company, on an annualized basis, for the six months ended June 30, 2017 and 2016 was 1.18% and 0.96%, respectively.

Return on average equity (ROE) measures the utilization of shareholders’ equity in generating net income. This measurement is affected by the same factors as ROA with consideration to how much of the Company’s assets are funded by shareholders. The ROE of the Company, on an annualized basis, for the six months ended June 30, 2017 and 2016 was 10.17% and 7.92%, respectively.

Net Interest Income

Net interest income is our primary source of revenue, representing the difference between interest and fees earned on interest-earning assets and the interest paid on deposits and other interest-bearing liabilities. The level of net interest income is impacted primarily by variations in the volume and mix of these assets and liabilities, as well as changes in interest rates. Net interest income was $13.1 million and $12.5 million for the six months ended June 30, 2017 and 2016, respectively, which represents an increase of $659 thousand or 5.29%. Net interest income was $6.8 million and $6.3 million for the three months ended June 30, 2017 and 2016, respectively, which represents an increase of $410 thousand or 6.46%. The increase in net interest income was driven by an increase in the securities available for sale portfolio and the loan portfolio, as well as a decrease in the average balance of Federal Home Loan Bank advances. Average interest earning assets increased $36.6 million when comparing the six months ended June 30, 2016 to the six months ended June 30, 2017 while the average yield decreased by six basis points over that same period.

Total interest income was $13.6 million and $13.1 million for the six months ended June 30, 2017 and 2016, respectively, which represents an increase of $507 thousand or 3.88%. Total interest income was $7.0 million and $6.6 million for the three months ended June 30, 2017 and 2016, respectively, which represents an increase of $362 thousand or 5.45%. Total interest expense was $452 thousand and $604 thousand for the six months ended June 30, 2017 and 2016, respectively, which represents a decrease of $152 thousand or 25.17%. Total interest expense was $249 thousand and $297 thousand for the three months ended June 30, 2017 and 2016, respectively, which represents a decrease of $48 thousand or 16.16%. The decrease in interest expense is primarily attributable to the decrease in the average balance of FHLB advances.

The net interest margin was 4.12% and 4.16% for the six months ended June 30, 2017 and 2016, respectively. The net interest margin is calculated by dividing tax-equivalent net interest income by total average earnings assets. Tax-equivalent net interest income is calculated by adding the tax benefit on certain securities and loans, whose interest is tax-exempt, to total interest income then subtracting total interest expense. The tax rate used to calculate the tax benefit was 34% for 2017 and 2016. The following table reconciles tax-equivalent net interest income, which is not a measurement under accounting principles generally accepted in the United States of America (GAAP), to net interest income.

Net interest income and net interest margin may experience some decline in the face of rising rates as interest bearing liabilities are repriced or replaced more rapidly than interest earning assets.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)		(in thousands)	
GAAP Financial Measurements:				
Interest Income - Loans	$6,108	$5,883	$11,844	$11,592
Interest Income - Securities and Other Interest-Earnings Assets	896	759	1,726	1,471
Interest Expense - Deposits	218	194	421	395
Interest Expense - Interest Rate Swap	—	39	—	80
Interest Expense - Other Borrowings	31	64	31	129
Total Net Interest Income	$6,755	$6,345	$13,118	$12,459
Non-GAAP Financial Measurements:				
Add: Tax Benefit on Tax-Exempt Interest Income - Loans (1)	$27	$30	$55	$58
Add: Tax Benefit on Tax-Exempt Interest Income - Securities (1)	139	119	270	239
Total Tax Benefit on Tax-Exempt Interest Income	$166	$149	$325	$297
Add: Interest Expense - Interest Rate Swap (2)	—	39	—	80
Tax-Equivalent Net Interest Income	$6,921	$6,533	$13,443	$12,836

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

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

The tax-equivalent yield on earning assets decreased from 4.32% to 4.26% for the six months ended June 30, 2016 and 2017, respectively. During that same time, the tax-equivalent yield on securities decreased 17 basis points from 3.23% to 3.06%. The tax equivalent yield on loans decreased seven basis points from 4.63% for the six months ended June 30, 2016 to 4.56% for the same time period in 2017. During that same time, the yield on interest-bearing deposits in other banks increased 41 basis points from 0.47% to 0.88%. The decrease in the tax-equivalent yield on loans and securities was the main driver behind the decrease in tax-equivalent yield on earning assets.

The average rate on interest bearing liabilities decreased five basis points from 0.27% for the six months ended June 30, 2016 to 0.22% for the same time period in 2017. The average rate on interest bearing deposits stayed stable during that same time. When loan demand exceeds deposit growth, the Company may borrow from the FHLB in the form of short and long term advances. All outstanding advances were paid off during the second half of 2016, with only one new short-term advance being originated in May 2017, resulting in an overall decrease in interest expense and cost of funds. The FHLB advance outstanding during 2016 had an interest rate of 1.30%, while the new advance in May 2017 had an interest rate of 1.02%.

Provision for Loan Losses

The provision for loan losses is based upon management’s estimate of the amount required to maintain an adequate allowance for loan losses as discussed within the Critical Accounting Policies section above. The allowance represents an amount that, in management’s judgment, will be adequate to absorb probable losses inherent in the loan portfolio. Management’s judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower’s ability to repay and the value of collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective because it requires estimates that are susceptible to significant revision as more information becomes available. The amount of provision for loan losses is affected by several factors including the growth rate of loans, net charge-offs (recoveries), and the estimated amount of inherent losses within the loan portfolio. The (recovery of) provision for loan losses was $(757) thousand and $79 thousand for the six months ended June 30, 2017 and 2016, respectively. The (recovery of) loan losses for the six months ended June 30, 2017 reflects primarily a decline in the historical loss experience utilized in our allowance model as well as lower specific reserves on remaining impaired loans. In addition there was a large recovery of $470 thousand during the first quarter of 2017 and two large recoveries totaling $196 thousand during the second quarter of 2017.

Noninterest Income

Total noninterest income for the six months ended June 30, 2017 and 2016 was $3.3 million and $3.4 million, respectively, which represents a decrease of $102 thousand or 3.02%. A decrease of $140 thousand or 8.06% was recorded when comparing the three months ended June 30, 2017 and 2016. Management reviews the activities which generate noninterest income on an ongoing basis.

The following table provides the components of noninterest income for the three and six months ended June 30, 2017 and 2016, which are included within the respective Consolidated Statements of Income headings. Variances that the Company believes require explanation are discussed below the table.

(dollars in thousands)	Three Months Ended June 30, 2017	2016	$ Change	% Change	Six Months Ended June 30, 2017	2016	$ Change	% Change
Income from fiduciary activities	$309	$380	$(71)	(19)%	$601	$708	$(107)	(15)%
Service charges on deposit accounts	295	290	5	2%	594	580	14	2%
Other service charges and fees	957	992	(35)	(4)%	1,910	1,821	89	5%
Gain on sale of securities	1	—	1	NM	51	86	(35)	NM
Other operating income	36	76	(40)	(53)%	115	178	(63)	(35)%
Total noninterest income	$1,598	$1,738	$(140)	(8)%	$3,271	$3,373	$(102)	(3)%

NM - Not Meaningful

Income from fiduciary activities decreased during the three and six months ended June 30, 2017 when compared to the same periods in 2016. The amount of income from fiduciary activities is determined by the number of active accounts and total assets under management. Also, income fluctuated due to changes in market value. These fluctuations during the three and six months ended June 30, 2017 do not necessarily indicate future results.

Other operating income decreased for the three and six months ended June 30, 2017 when compared to the same periods in 2016. The decrease can be attributed almost solely to the adjustment of the interest rate swap derivative contract to fair value. As previously reported, the Company's cash flow hedge was derecognized upon the retirement of the trust preferred capital notes during the third quarter of 2015. As a result, adjustments of the derivative contract to fair value in the amounts of $38 thousand and $71 thousand for the three and six months ended June 30, 2016, respectively, were recognized through Other operating income in the Consolidated Statements of Income. The derivative contract expired on December 1, 2016.

Noninterest Expenses

Total noninterest expenses increased $72 thousand or 0.63% from $11.4 million to $11.5 million for the six months ended June 30, 2016 compared to the six months ended June 30, 2017. Total noninterest expenses decreased $85 thousand or 1.46% for the three months ended June 30, 2017 compared to the same period in 2016.

The following table presents the components of noninterest expense for the three and six months ended June 30, 2017 and 2016, which are included within the respective Consolidated Statements of Income headings.

(dollars in thousands)	Three Months Ended June 30, 2017	2016	$ Change	% Change	Six Months Ended June 30, 2017	2016	$ Change	% Change
Salaries and employee benefits	$3,364	$3,313	$ 51	2 %	$6,714	$6,577	$ 137	2 %
Occupancy expenses	367	367	—	— %	744	775	(31)	(4)%
Equipment expenses	259	223	36	16 %	498	469	29	6 %
Advertising and marketing expenses	175	185	(10)	(5)%	353	347	6	2 %
Stationary and supplies	47	51	(4)	(8)%	88	101	(13)	(13)%
ATM network fees	183	259	(76)	(29)%	403	436	(33)	(8)%
Other real estate owned expense	10	2	8	NM	11	2	9	NM
Loss (gain) on valuation adjustments and sales of other real estate owned	—	47	(47)	NM	(1)	47	(48)	NM
FDIC assessment	55	99	(44)	(44)%	107	204	(97)	(48)%
Computer software expense	159	131	28	21 %	355	267	88	33 %
Bank franchise tax	134	125	9	7 %	259	251	8	3 %
Professional fees	267	281	(14)	(5)%	558	509	49	10 %
Data processing fees	139	132	7	5 %	256	196	60	31 %
Other operating expenses	588	617	(29)	(5)%	1,113	1,205	(92)	(8)%
Total noninterest expenses	$5,747	$5,832	$ (85)	(1)%	$11,458	$11,386	$ 72	1 %

NM - Not Meaningful

Equipment expenses increased during the three months ended June 30, 2017 over 2016. During the second quarter of 2017, expenses were incurred to change vault and teller locks at all branches to allow branches to have more staffing flexibility while still maintaining proper segregation of duties and dual control access to cash.

ATM network fees decreased during the three months ended June 30, 2017 in comparison to 2016. This is due mainly to changes in activity from customers which can fluctuate between periods.

FDIC assessments decreased during the three and six months ended June 30, 2017 over 2016. 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%.

Computer software expense increased during the three and six months ended June 30, 2017 over 2016. Fees paid to our core software provider have increased due to an increase in asset size. In addition, the Company purchased a new malware protection software during 2017 which has resulted in an increase in computer software expense.

Professional fees during the six months ended June 30, 2017 have increased over the same period in 2016. Increased audit and legal fees contributed to the higher level of professional expenses.

Data processing fees increased during the six months ended June 30, 2017 over 2016. The majority of the increase is due to an increase in both the number of customers and the number of transactions being performed.

The efficiency ratio of the Company was 68.70% and 70.68% for the six months ended June 30, 2017 and 2016. The efficiency ratio is not a measurement under accounting principles generally accepted in the United States. It is calculated by dividing noninterest expense by the sum of tax equivalent net interest income and noninterest income excluding gains and losses on the investment portfolio. The tax rate utilized is 34%. The Company calculates and reviews this ratio as a means of evaluating operational efficiency.

The calculation of the efficiency ratio for the three and six months ended June 30, 2017 and 2016 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)		(in thousands)	
Summary of Operating Results:				
Noninterest expenses	$5,747	$5,832	$11,458	$11,386
Less: Loss (gain) on sales of other real estate owned	—	47	(1)	47
Adjusted noninterest expenses	$5,747	$5,785	$11,459	$11,339
Net interest income	6,755	$6,345	$13,118	$12,459
Noninterest income	1,598	1,738	3,271	3,373
Less: Gain on sales of securities	1	—	51	86
Less: (Loss) on the sale and disposal of premises and equipment	(5)	—	(11)	—
Less: (Loss) on sale of of repossessed assets	(4)	—	(6)	—
Adjusted noninterest income	$1,606	$1,738	$3,237	$3,287
Tax equivalent adjustment (1)	166	149	325	297
Total net interest income and noninterest income, adjusted	$8,527	$8,232	$16,680	$16,043
Efficiency ratio	67.40 %	70.27 %	68.70 %	70.68 %

(1) Includes tax-equivalent adjustments on loans and securities using the federal statutory tax rate of 34%.

Income Taxes

Income tax expense was $1.6 million and $1.2 million during the six months ended June 30, 2017 and 2016, respectively. The effective tax rate was 28.46% and 28.21% for the six months ended June 30, 2017 and 2016, respectively. The effective tax rate is below the statutory rate of 34% due primarily to tax-exempt income on investment securities and loans. The effective tax rate is also impacted by tax credits on qualified affordable housing project investments as discussed in Note 13 to the Consolidated Financial Statements.

FINANCIAL CONDITION

Securities

Total securities available for sale were $131.7 million at June 30, 2017, compared to $119.3 million at December 31, 2016. This represents an increase of $12.4 million or 10.39%. The Company purchased $20.7 million in securities during the six months ended June 30, 2017. The Company had total maturities, calls, and principal repayments of $4.8 million. There were $4.9 million in sales during the six months ended June 30, 2017. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity at June 30, 2017. Note 4 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio at June 30, 2017 and December 31, 2016. The Company had a net unrealized gain on available for sale securities of $1.5 million at June 30, 2017 as compared to a net unrealized loss of $94 thousand at December 31, 2016. 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).

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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 $554.2 million and $516.9 million at June 30, 2017 and December 31, 2016, respectively. This represents an increase of $37.24 million or 7.20% during the six months ended June 30, 2017. The ratio of gross loans to deposits increased during the six months ended June 30, 2017 from 85.60% at December 31, 2016 to 87.69% at June 30, 2017 due to strong loan growth during the first half of 2017.

The loan portfolio consists primarily of loans for owner-occupied single family dwellings and loans secured by commercial real estate. Note 5 to the Consolidated Financial Statements provides the composition of the loan portfolio at June 30, 2017 and December 31, 2016.

Residential real estate loans were $229.9 million or 41.49% and $231.5 million or 44.79% of total loans at June 30, 2017 and December 31, 2016, respectively. Commercial real estate loans were $238.4 million or 43.03% and $208.5 million or 40.34% of total loans at June 30, 2017 and December 31, 2016, respectively. This represents an increase of $29.9 million or 14.35% during the six months ended June 30, 2017. Consumer installment loans were $12.5 million or 2.26% and $12.7 million or 2.45% of total loans at June 30, 2017 and December 31, 2016, respectively. Commercial and industrial loans were $35.7 million or 6.44% and $30.3 million or 5.87% of total loans at June 30, 2017 and December 31, 2016, respectively. This represents an increase of $5.3 million or 17.59% during the six months ended June 30, 2017. During the six months ended June 30, 2017, loan growth was mainly concentrated in commercial real estate and commercial and industrials loans.

Allowance for Loan Losses

The purpose of, and the methods for, measuring the allowance for loan losses are discussed in the Critical Accounting Policies section above. Note 5 to the Consolidated Financial Statements shows the activity within the allowance for loan losses during the six months ended June 30, 2017 and 2016 and the year ended December 31, 2016. Charged-off loans were $140 thousand and $155 thousand for the six months ended June 30, 2017 and 2016, respectively. Recoveries were $799 thousand and $90 thousand for the six months ended June 30, 2017 and 2016, respectively. This resulted in net recoveries (charge-offs) of $659 thousand and $(65) thousand for the six months ended June 30, 2017 and 2016, respectively. One large recovery of $470 thousand during the first quarter of 2017 and two large recoveries totaling $196 thousand during the second quarter of 2017 contributed to the total net recovery for the six months ended June 30, 2017. The allowance for loan losses as a percentage of loans was 0.80% at June 30, 2017 and 0.87% at December 31, 2016. The allowance for loan losses was 78.68% of nonperforming loans at June 30, 2017 and 64.37% of nonperforming loans at December 31, 2016. Nonperforming loans decreased by $1.4 million during the six months ended June 30, 2017 due mainly to the payoff of a few loans that were in nonaccrual status at December 31, 2016. All nonaccrual and other impaired loans were evaluated for impairment and any specific allocations which were provided for as necessary. Management believes that the allowance for loan losses is currently adequate to absorb probable losses inherent in the loan portfolio. Given the unpredictability of the economic environment, there is a potential for increases in past due loans, nonperforming loans and other real estate owned. However, the Company believes that the allowance for loan losses will be maintained at a level adequate to mitigate any negative impact resulting from such increases.

Nonperforming Assets and Other Assets

Nonperforming assets consist of nonaccrual loans, repossessed assets, other real estate owned (foreclosed properties), and loans past due 90 days or more and still accruing. Nonaccrual loans were $5.6 million and $7.0 million at June 30, 2017 and December 31, 2016, respectively. Other real estate owned was $106 thousand at June 30, 2017 and $370 thousand at December 31, 2016. The Company held two parcels of land in other real estate owned with an average balance of $53 thousand at June 30, 2017 and held four properties with an average balance of $93 thousand at December 31, 2016. The percentage of nonperforming assets to loans and other real estate owned was 1.03% at June 30, 2017 and 1.42% at December 31, 2016, respectively. There were no loans past due 90 days or more and still accruing interest at June 30, 2017. Total loans past due 90 days or more and still accruing interest were $8 thousand at December 31, 2016. The majority of the decrease to nonperforming assets, as mentioned above, was due mainly to the payoff of a few loans that were in nonaccrual status at December 31, 2016. Total past due loans, as disclosed in note 5 to the Consolidated Financial Statements, increased by $3.6 million during the six months ended June 30, 2017. This increase is due mainly to a $4.1 million loan secured by two large, multi-acre residential properties located in Loudoun County, Virginia. This loan was placed on nonaccrual status during 2016 and was identified as an impaired loan at December 31, 2016 and June 30, 2017. No specific reserve was required for this loan at either period end based on the impairment calculation. While this loan was considered current at December 31, 2016, no payments were received during the first six months of 2017 which caused the loan to be over 90 days past due at June 30, 2017.

During the six months ended June 30, 2017, the Bank placed four loans totaling $118 thousand on nonaccrual status. These loans are secured by real estate. Management evaluates the financial condition of these borrowers and the value of any collateral on these loans. The results of these evaluations are used to estimate the amount of losses which may be realized on the disposition of these nonaccrual loans.

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

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

In addition, the Company may, under certain circumstances, restructure loans in troubled debt restructurings as a concession to a borrower when the borrower is experiencing financial distress. Formal, standardized loan restructuring programs are not utilized by the Company. Each loan considered for restructuring is evaluated based on customer circumstances and may include modifications to one or more loan provisions. Such restructured loans are included in impaired loans. However, restructured loans are not necessarily considered nonperforming assets. At June 30, 2017, the Company had $5.1 million in restructured loans with specific allowances totaling $267 thousand. At December 31, 2016, the Company had $7.3 million in restructured loans with specific allowances totaling $335 thousand. At June 30, 2017 and December 31, 2016, total restructured loans performing under the restructured terms and accruing interest were $4.4 million and $5.7 million, respectively. Three loans, totaling $700 thousand, were in nonaccrual status at June 30, 2017. Six loans, totaling $1.6 million, were in nonaccrual status at December 31, 2016.

Deposits

Total deposits were $632.0 million and $603.9 million at June 30, 2017 and December 31, 2016, respectively. This represents an increase of $28.1 million or 4.66% during the six months ended June 30, 2017. Note 7 to the Consolidated Financial Statements provides the composition of total deposits at June 30, 2017 and December 31, 2016.

Noninterest-bearing demand deposits which are comprised of checking accounts, increased $9.2 million or 4.39% from $208.9 million at December 31, 2016 to $218.1 million at June 30, 2017. Savings and interest-bearing demand deposits, which include NOW accounts, money market accounts and regular savings accounts increased $6.1 million or 2.00% from $306.8 million at December 31, 2016 to $313.0 million at June 30, 2017. Time deposits increased $12.8 million or 14.56% from $88.1 million at December 31, 2016 to $100.9 million at June 30, 2017. This is comprised of an increase in time deposits of $250,000 and more of $14.7 million or 70.24% and a decrease in time deposits of less than $250,000 of $1.9 million or 2.79%. Certificates of deposit also included $2.4 million and $2.2 million in brokered certificates of deposit at June 30, 2017 and December 31, 2016, respectively.

CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity at June 30, 2017 was $83.2 million, reflecting a percentage of total assets of 11.18%, as compared to $79.4 million and 11.34% at December 31, 2016. During the six months ended June 30, 2016 and 2017, the Company declared dividends of $0.40 and $0.44 per share, respectively. The Company has a Dividend Investment Plan that reinvests the dividends of the shareholder in Company stock.

The new Basel III rules, effective January 1, 2015, changed the components of regulatory capital and changed the way in which risk ratings are assigned to various categories of bank assets. Also, a new Tier I common risk-based ratio was defined. The new rules resulted in only minor changes to the Company's Tier I and Total risk-based capital, and increased risk-weighted assets due to higher risk weightings for short-term loan commitments and past due and nonaccrual loans. Under the Basel III requirements, at June 30, 2017, the Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions.
Federal regulatory risk-based capital guidelines require percentages to be applied to various assets, including off-balance sheet assets, based on their perceived risk in order to calculate risk-weighted assets. Tier 1 capital consists of total shareholders' equity less net unrealized gains and losses on available for sale securities. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses.
For capital adequacy purposes, during 2016 and 2017, financial institutions must maintain a Tier 1 common equity risk-based capital ratio of 4.50%, a Tier 1 risk-based capital ratio of at least 6.00%, a Total risk-based capital ratio of at least 8.00% and a minimum Tier 1 leverage ratio of 4.00%. The Company's policy requires a Tier 1 common equity risk-based capital ratio of 7.00%, a Tier 1 risk-based capital ratio of at least 8.50%, a total risk-based capital ratio of at least 10.50% and a minimum Tier 1 leverage ratio of 6.50%. These include the 2.5% capital conservation buffer required under the rules to be phased-in over a four-year period and as noted, we apply this buffer internally to the minimums for all of our ratios. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets. Beginning on January 1, 2016, the capital conservation buffer requirement began its phase-in in at 0.625% of risk-weighted assets, and will increase by the same amount each year until fully implemented at 2.5% on January 1, 2019.
The Company's Tier 1 common risk-based capital ratio was 14.37% at June 30, 2017 as compared to 15.68% at December 31, 2016. The Company's Tier 1 risk-based capital ratio was 14.37% at June 30, 2017 as compared to 15.68% at December 31, 2016. The Company's total risk-based capital ratio was 15.15% at June 30, 2017 as compared to 16.58% at December 31, 2016. The Company's Tier 1 capital to average total assets ratio was 11.53% at June 30, 2017 as compared to 11.84% at December 31, 2016. The Company monitors these ratios on a quarterly basis and has several strategies, including without limitation the issuance of common stock, to ensure that these ratios remain above regulatory minimums. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

LIQUIDITY

Liquidity management involves meeting the present and future financial obligations of the Company with the sale or maturity of assets or with the occurrence of additional liabilities. Liquidity needs are met with cash on hand, deposits in banks, federal funds sold, securities classified as available for sale and loans maturing within one year. At June 30, 2017, liquid assets totaled $255.8 million as compared to $248.1 million at December 31, 2016. These amounts represent 38.70% and 39.97% of total liabilities at June 30, 2017 and December 31, 2016, respectively. The Company minimizes liquidity demand by utilizing core deposits to fund asset growth. Securities provide a constant source of liquidity through paydowns and maturities. Also, the Company maintains short-term borrowing arrangements, namely federal funds lines of credit, with larger financial institutions as an additional source of liquidity. Finally, the Bank's membership with the Federal Home Loan Bank of Atlanta provides a source of borrowings with numerous rate and term structures. The Company's senior management monitors the liquidity position regularly and attempts to maintain a position which utilizes available funds most efficiently.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in Quantitative and Qualitative Disclosures about Market Risk as reported in the 2016 Form 10-K.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of June 30, 2017 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

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

There were no changes in the Company's internal control over financial reporting during the Company's quarter ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2016.

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

The following table details the Company's purchases of its common stock during the second quarter of 2017 pursuant to the Stock Repurchase Program. The Company authorized 150,000 shares for repurchase under the Stock Repurchase program. The Program has an expiration date of June 30, 2018.

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

			as Part of Publicly Announced Plan	Be Purchased Under the Plan
April 1 - April 30, 2017	—	$ —	—	51,536
May 1 - May 31, 2017	5,194	29.75	5,194	46,342
June 1 - June 30, 2017	—	—	—	46,342
	5,194	$ 27.65	—	46,342

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

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

Exhibit No.	Description
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification by Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following materials from the Eagle Financial Services, Inc. Quarterly Report on Form 10-Q for the quarter ended June 30, 2017 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.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, this 14th day of August, 2017.

Eagle Financial Services, Inc.

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

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

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