

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2014

Commission File Number: 0-20146

EAGLE FINANCIAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of
incorporation or organization)

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

2 East Main Street
P.O. Box 391
Berryville, Virginia
(Address of principal executive offices)

22611
(Zip Code)

(540) 955-2510

(Registrant's telephone number, including area code)

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

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

Common Stock, Par Value \$2.50
(Title of class)

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company.)

Smaller reporting company

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

The aggregate market value of the voting common equity held by non-affiliates of the registrant at June 30, 2014 was \$63,481,957.

The number of shares of the registrant's Common Stock (\$2.50 par value) outstanding as of March 9, 2015 was 3,481,774.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the 2015 Annual Meeting of Shareholders are incorporated by reference into Part III.

EAGLE FINANCIAL SERVICES, INC.
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PART I

Item 1. Business

General

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

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

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

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

In addition to the Bank, the Company has a wholly owned subsidiary, Eagle Financial Statutory Trust II, which was formed in connection with the issuance of \$7,000,000 in trust preferred securities in 2007. The Company is also a general partner in a low income housing project. The Company’s subsidiary, Bank of Clarke County, is a partner in Bankers Title Shenandoah, LLC, which sells title insurance, is an investor in Virginia Bankers Insurance Center, LLC, which serves as the broker for insurance sales through its member banks, and is an investor in State Theatre Owner, LLC which rehabilitated the State Theatre of Culpeper, Virginia.

Employees

The Company, including the Bank, had 48 officers, 108 other full-time and 23 part-time employees (or 164 full-time equivalent employees) at December 31, 2014. None of the Company’s employees are represented by a union or covered under a collective bargaining agreement. The Company considers relations with its employees to be excellent.

Securities and Exchange Commission Filings

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

Competition

There is significant competition for both loans and deposits within the Company's trade area. Competition for loans comes from other commercial banks, savings banks, credit unions, mortgage brokers, finance companies, insurance companies, and other institutional lenders. Competition for deposits comes from other commercial banks, savings banks, credit unions, brokerage firms, and other financial institutions. Based on total deposits at June 30, 2014 as reported to the FDIC, the Company has 6.6% of the total deposits in its market area. The Company's market area includes Clarke County, Frederick County, Loudoun County and the City of Winchester.

Supervision and Regulation

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

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

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

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

Some of the activities that the Federal Reserve Board has determined by regulation to be closely related to the business of a bank holding company include making or servicing loans and specific types of leases, performing specific data processing services and acting in some circumstances as a fiduciary or investment or financial adviser.

With some limited exceptions, the Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve before:

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

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

In November 1999, Congress enacted the Gramm-Leach-Bliley Act ("GLBA"), which made substantial revisions to the statutory restrictions separating banking activities from other financial activities. Under the GLBA, bank holding companies that are well-capitalized and well-managed and meet other conditions can elect to become "financial holding companies." As financial holding companies, they and their subsidiaries are permitted to acquire or engage in previously impermissible activities such as insurance underwriting, securities underwriting and distribution, travel agency activities, insurance agency activities, merchant banking and other activities that the Federal Reserve determines to be financial in nature or complementary to these activities. Financial holding companies continue to be subject to the overall oversight and supervision of the Federal Reserve, but the GLBA applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. Although the Company has not elected to become a financial holding company in order to exercise the broader activity powers provided by the GLBA, the Company may elect to do so in the future.

Payment of Dividends. The Company is a legal entity separate and distinct from the Bank. The majority of the Company's revenues are from dividends paid to the Company by the Bank. The Bank is subject to laws and regulations that limit the amount of dividends it can pay. In addition, both the Company and the Bank are subject to various regulatory restrictions relating to the payment of dividends, including requirements to maintain capital at or above regulatory minimums. Banking regulators have indicated that banking organizations should generally pay dividends only if the organization's current earnings are sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition. The Company does not expect that any of these laws, regulations or policies will materially affect the Bank's ability to pay dividends to the Company. Refer to Item 5 for additional information on dividend restrictions. During the year ended December 31, 2014, the Bank paid \$1.6 million in dividends to the Company. The Company paid cash dividends of \$1.9 million to shareholders during 2014.

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

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

Capital Requirements. The Federal Reserve Board has issued risk-based and leverage capital guidelines applicable to banking organizations that it supervises. Under the risk-based capital requirements, the Company and the Bank are each generally required to maintain a minimum ratio of total capital to risk-weighted assets of 8%. At least half of the total capital must be composed of "Tier 1 Capital", which is defined as common equity, retained earnings and qualifying perpetual preferred stock, less certain intangibles. The remainder may consist of "Tier 2 Capital", which is defined as specific subordinated debt, some hybrid capital instruments and other qualifying preferred stock and a limited amount of the loan loss allowance. In addition, each of the federal banking regulatory agencies has established minimum leverage capital requirements for banking organizations. Under these requirements, banking organizations must maintain a minimum ratio of Tier 1 capital to adjusted average quarterly assets equal to 3% to 5%, subject to federal bank regulatory evaluation of an organization's overall safety and soundness. In sum, the capital measures used by the federal banking regulators are as follows:

- the Total Capital ratio, which is the total of Tier 1 Capital and Tier 2 Capital;
- the Tier 1 Capital ratio; and
- the leverage ratio.

Under these regulations, a bank will be classified as follows:

- "well capitalized" if it has a Total Capital ratio of 10% or greater, a Tier 1 Capital ratio of 6% or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure;
- "adequately capitalized" if it has a Total Capital ratio of 8% or greater, a Tier 1 Capital ratio of 4% or greater, and a leverage ratio of 4% or greater – or 3% in certain circumstances – and is not well capitalized;
- "undercapitalized" if it has a Total Capital ratio of less than 8%, a Tier 1 Capital ratio of less than 4%—or 3% in certain circumstances;
- "significantly undercapitalized" if it has a Total Capital ratio of less than 6%, a Tier 1 Capital ratio of less than 3%, or a leverage ratio of less than 3%; or
- "critically undercapitalized" if its tangible equity is equal to or less than 2% of average quarterly tangible assets.

The risk-based capital standards of the Federal Reserve Board explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution's overall capital adequacy. The capital guidelines also provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a banking organization's capital adequacy.

The Dodd-Frank Act contains a number of provisions dealing with capital adequacy of insured depository institutions and their holding companies, which may result in more stringent capital requirements. Under the Collins Amendment to the Dodd-Frank Act, federal regulators have been directed to establish minimum leverage and risk-based capital requirements for, among other entities, banks and bank holding companies on a consolidated basis. These minimum requirements can't be less than the generally applicable leverage and risk-based capital requirements established for insured depository institutions nor quantitatively lower than the leverage and risk-based capital requirements established for insured depository institutions that were in effect as of July 21, 2010. These requirements in effect create capital level floors for bank holding companies similar to those in place currently for insured depository institutions. The Collins Amendment also excludes trust preferred securities issued after May 19, 2010 from being included in Tier 1 capital unless the issuing company is a bank holding company with less than \$500 million in total assets. Trust preferred securities issued prior to that date will continue to count as Tier 1 capital for bank holding companies with less than \$15 billion in total assets, and such securities will be phased out of Tier 1 capital treatment for bank holding companies with over \$15 billion in total assets over a three-year period beginning in 2014. Accordingly, the Company's trust preferred securities will continue to qualify as Tier 1 capital.

The FDIC may take various corrective actions against any undercapitalized bank and any bank that fails to submit an acceptable capital restoration plan or fails to implement a plan acceptable to the FDIC. These powers include, but are not limited to, requiring the institution to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions by any bank holding company that controls the institution, requiring divestiture by the institution of its subsidiaries or by the holding company of the institution itself, requiring new election of directors, and requiring the dismissal of directors and officers. The Bank presently maintains sufficient capital to remain well capitalized under these guidelines.

In 2013, the Federal Reserve, the FDIC and the OCC approved a new rule that will substantially amend the regulatory risk-based capital rules applicable to us. The final rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. The final rule includes new minimum risk-based capital and leverage ratios which will be effective for us on January 1, 2015, and refines the definition of what constitutes "capital" for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 ("CET1") capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6%, which is increased from 4%; (iii) a total capital ratio of 8%, which is unchanged from the current rules; and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a "capital conservation buffer" of 2.5% above the new regulatory minimum capital ratios, and when fully effective in 2019, will result in the following minimum ratios: (a) a common equity Tier 1 capital ratio of 7.0%; (b) a Tier 1 to risk-based assets capital ratio of 8.5%; and (c) a total capital ratio of 10.5%. The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such activities.

In addition, the Basel III capital rules provide for a number of new deductions from and adjustments to capital and prescribe a standardized approach for risk weightings that expand the risk-weighting categories from the current four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories.

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

Interstate Banking and Branching. Current federal law authorizes interstate acquisitions of banks and bank holding companies without geographic limitation. Effective June 1, 1997, a bank headquartered in one state is authorized to merge with a bank headquartered in another state, as long as neither of the states had opted out of such interstate merger authority prior to such date. After a bank has established branches in a state through an interstate merger transaction, the bank may establish and acquire additional branches at any location in the state where a bank headquartered in that state could have established or acquired branches under applicable federal or state law.

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

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

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

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

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

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

Community Reinvestment Act. Under the Community Reinvestment Act and related regulations, depository institutions have an affirmative obligation to assist in meeting the credit needs of their market areas, including low and moderate-income areas, consistent with safe and sound banking practice. The Community Reinvestment Act directs each bank to maintain a public file containing specific information, including all written comments received from the public for the current year and each of the previous two calendar years that specifically relate to the bank's performance in helping to meet community credit needs. Depository institutions are periodically examined for compliance with the Community Reinvestment Act and are periodically assigned ratings in this regard. Banking regulators consider a depository institution's Community Reinvestment Act rating when reviewing applications to establish new branches, undertake new lines of business, and/or acquire part or all of another depository institution. An unsatisfactory rating can significantly delay or even prohibit regulatory approval of a proposed transaction by a bank holding company or its depository institution subsidiaries.

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

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

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

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

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

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

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

The GLBA adopts a system of functional regulation under which the Federal Reserve Board is designated as the umbrella regulator for financial holding companies, but financial holding company affiliates are principally regulated by functional regulators such as the FDIC for state nonmember bank affiliates, the Securities and Exchange Commission for securities affiliates, and state insurance regulators for insurance affiliates. It repeals the broad exemption of banks from the definitions of “broker” and “dealer” for purposes of the Securities Exchange Act of 1934, as amended. It also identifies a set of specific activities, including traditional bank trust and fiduciary activities, in which a bank may engage without being deemed a “broker,” and a set of activities in which a bank may engage without being deemed a “dealer.” Additionally, the new law makes conforming changes in the definitions of “broker” and “dealer” for purposes of the Investment Company Act of 1940, as amended, and the Investment Advisers Act of 1940, as amended.

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

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

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

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

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

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

- *FDIC Assessments.* The Dodd-Frank Act changes the assessment base for federal deposit insurance from the amount of insured deposits to average consolidated total assets less its average tangible equity. In addition, it increases the minimum size of the Deposit Insurance Fund (“DIF”) and eliminates its ceiling, with the burden of the increase in the minimum size on institutions with more than \$10 billion in assets.
- *Deposit Insurance.* As scheduled, the unlimited insurance for noninterest bearing transaction accounts provided under the Dodd-Frank Wall Street Reform and Consumer Protection Act expired on December 31, 2012. Deposits held in noninterest bearing transaction accounts are now aggregated with any interest bearing deposits the owner may hold in the same ownership category, and the combined total is insured up to at least \$250,000.
- *Interest on Demand Deposits.* The Dodd-Frank Act also provides that, effective one year after the date of enactment, depository institutions may pay interest on demand deposits, including business transaction and other accounts.
- *Interchange Fees.* The Federal Reserve set a cap on debit card interchange fees charged to retailers. While banks with less than \$10 billion in assets, such as the Bank, are exempted from this measure, it is likely that all banks could be forced by market pressures to lower their interchange fees or face potential rejection of their cards by retailers.
- *Consumer Financial Protection Bureau.* The Dodd-Frank Act centralizes responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau, responsible for implementing federal consumer protection laws, although banks below \$10 billion in assets will continue to be examined and supervised for compliance with these laws by their federal bank regulator.
- *Mortgage Lending.* New requirements are imposed on mortgage lending, including new minimum underwriting standards, restrictions concerning loan originator compensation, qualifications of, and registration or licensing of loan originators, special consumer protections for mortgage loans that do not meet certain provision qualifications, prohibitions and limitations on certain mortgage terms and various new mandated disclosures to mortgage borrowers.
- *Holding Company Capital Levels.* Bank regulators are required to establish minimum capital levels for holding companies that are at least as stringent as those currently applicable to banks. In addition, all trust preferred securities issued after May 19, 2010 will be counted as Tier 2 capital, but the Company’s currently outstanding trust preferred securities will continue to qualify as Tier 1 capital.
- *De Novo Interstate Branching.* National and state banks are permitted to establish de novo interstate branches outside of their home state, and bank holding companies and banks must be well-capitalized and well managed in order to acquire banks located outside their home state.
- *Transactions with Affiliates.* The Dodd-Frank Act enhances the requirements for certain transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including an expansion of the definition of “covered transactions” and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained.

- *Transactions with Insiders.* Insider transaction limitations are expanded through the strengthening of loan restrictions to insiders and the expansion of the types of transactions subject to the various limits, including derivative transactions, repurchase agreements, reverse repurchase agreements and securities lending or borrowing transactions. Restrictions are also placed on certain asset sales to and from an insider to an institution, including requirements that such sales be on market terms and, in certain circumstances, approved by the institution's board of directors.
- *Corporate Governance.* The Dodd-Frank Act includes corporate governance revisions that apply to all public companies, not just financial institutions, including with regard to executive compensation and proxy access to shareholders.

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

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

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

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

Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z). Pursuant to the Dodd-Frank Act, the CFPB issued a final rule on November 20, 2013 (effective on August 1, 2015), combining certain disclosures that consumers receive in connection with applying for and closing on a mortgage loan under the Truth in Lending Act and the Real Estate Settlement Procedures Act. The Bureau amended Regulation X (Real Estate Settlement Procedures Act) and Regulation Z (Truth in Lending) to establish new disclosure requirements and forms in Regulation Z for most closed-end consumer credit transactions secured by real property. In addition to combining the existing disclosure requirements and implementing new requirements imposed by the Dodd-Frank Act, the final rule provides extensive guidance regarding compliance with those requirements. The final rule applies to most closed-end consumer mortgages. It does not apply to home equity lines of credit, reverse mortgages, or mortgages secured by a mobile home or by a dwelling that is not attached to real property (in other words, land). The final rule also does not apply to loans made by a creditor who makes five or fewer mortgages in a year.

Item 1A. Risk Factors

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

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

As a financial institution, we are heavily regulated at the state and federal levels. As a result of the financial crisis and related global economic downturn that began in 2007, we have faced, and expect to continue to face, increased public and legislative scrutiny as well as stricter and more comprehensive regulation of our financial services practices. In July 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act includes significant changes in the financial regulatory landscape and will impact all financial institutions, including the Company and the Bank. Many of the provisions of the Dodd-Frank Act have begun to be or will be implemented over the next several years and will be subject both to further rulemaking and the discretion of applicable regulatory bodies. Because the ultimate impact of the Dodd-Frank Act will depend on future regulatory rulemaking and interpretation, we cannot predict the full effect of this legislation on our businesses, financial condition or results of operations. Among other things, the Dodd-Frank Act and the regulations implemented thereunder could limit debit card interchange fees, increase FDIC assessments, impose new requirements on mortgage lending, and establish more stringent capital requirements on bank holding companies. As a result of these and other provisions in the Dodd-Frank Act, we could experience additional costs, as well as limitations on the products and services we offer and on our ability to efficiently pursue business opportunities, which may adversely affect our businesses, financial condition or results of operations. In addition, implementation of the BASEL III requirements will increase required capital minimums and could increase compliance costs due to their complexity.

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

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

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

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

Difficult market conditions have adversely affected our industry.

Dramatic declines in the housing market, falling home prices and increasing foreclosures, and unemployment and under-employment have negatively impacted the credit performance of real estate related loans and resulted in significant write-downs of asset values by financial institutions. These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting economic pressure on consumers and lack of confidence in the financial markets has adversely affected our business and results of operations. Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for credit losses, although these conditions have shown signs of stabilization in 2013 and 2014. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial institutions industry.

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

The Company's branches are located in the counties of Clarke, Frederick and Loudoun, and the City of Winchester. The current recession presents numerous challenges to the way we do business. Poor economic conditions, which are beyond our control, negatively impact the Company's financial condition and performance. These conditions influence the volume of loans and deposits, the asset quality of the loan portfolio, and pricing of loans and deposits.

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

The Company and the Bank are each subject to capital adequacy guidelines and other regulatory requirements specifying minimum amounts and types of capital which each must maintain. From time to time, regulators implement changes to these regulatory capital adequacy guidelines. Under the Dodd-Frank Act, the federal banking agencies have established stricter capital requirements and leverage limits for banks and bank holding companies that are based on the Basel III regulatory capital reforms. If the Company and the Bank fail to meet these minimum capital guidelines and/or other regulatory requirements, the Company could be subject to regulatory restrictions, including limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses, or experience other adverse consequences that could cause its financial condition to be materially and adversely affected.

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

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

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

At December 31, 2014, loans secured by real estate totaled \$425.5 million and represented 90.57% of the Company's loan portfolio. If we experience further adverse changes in the local real estate market or in the local or national economy, borrowers' ability to pay these loans may be further impaired, which could impact the Company's financial performance. The Company attempts to limit its exposure to this risk by applying good underwriting practices at origination, evaluating the appraisals used to establish property values, and routinely monitoring the financial condition of borrowers. If the value of real estate serving as collateral for the loan portfolio were to continue to decline materially, a significant part of the loan portfolio could become under-collateralized. If the loans that are secured by real estate become troubled when real estate market conditions are declining or have declined, in the event of foreclosure, the Company may not be able to realize the amount of collateral that was anticipated at the time of originating the loan. In that event, the Company might have to increase the provision for loan losses, which could have a material adverse effect on its operating results and financial condition.

An inadequate allowance for loan losses would reduce our earnings.

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

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

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

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

The soundness of other financial institutions could adversely affect us.

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

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

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

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

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

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company owns or leases buildings which are used in normal business operations. The Company's corporate headquarters, and that of Bank of Clarke County, is located at 2 East Main Street, Berryville, Virginia, 22611. At December 31, 2014, Bank of Clarke County operated twelve full-service branches and one drive-through only facility in the Virginia communities of Berryville, Winchester, Boyce, Stephens City, Round Hill and Purcellville. See Note 1 "Nature of Banking Activities and Significant Accounting Policies" and Note 6 "Bank Premises and Equipment, Net" in the "Notes to the Consolidated Financial Statements" of this Form 10-K for information with respect to the amounts at which bank premises and equipment are carried and commitments under long-term leases.

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

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

None.

PART II

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

The Company’s common stock is not listed for trading on a registered exchange. Shares of the common stock of the Company are traded on the over-the-counter (OTC) market and quoted on the OTC Bulletin Board under the symbol “EFSI.” The OTC Bulletin Board provides information about the common stock to professional market makers who match sellers with buyers. Securities brokers can obtain information from the OTC Bulletin Board when working with clients. When a client decides to initiate a transaction, the broker will contact one of the stock’s market makers.

The Company has a limited record of trades involving its common stock in the sense of “bid” and “ask” prices or in highs and lows. The effort to accurately disclose trading prices is made more difficult due to the fact that price per share information is not required to be disclosed to the Company when shares of its stock have been sold by holders and purchased by others. The table titled “Common Stock Market Price and Dividend Data” summarizes the high and low sales prices of shares of the Company’s common stock on the basis of trades known to the Company (including trades through the OTC Bulletin Board) and dividends declared during 2014 and 2013. The Company may not be aware of the per share price of all trades made.

Common Stock Market Price and Dividend Data

	2014		2013		Dividends Per Share	
	High	Low	High	Low	2014	2013
1st Quarter	\$23.45	\$21.29	\$23.50	\$21.40	\$0.19	\$0.19
2nd Quarter	23.60	22.40	23.35	22.10	0.19	0.19
3rd Quarter	24.10	22.51	24.80	23.35	0.19	0.19
4th Quarter	24.25	22.51	23.95	20.55	0.20	0.19

As of March 9, 2015, the Company had approximately 1,078 shareholders of record.

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

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

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

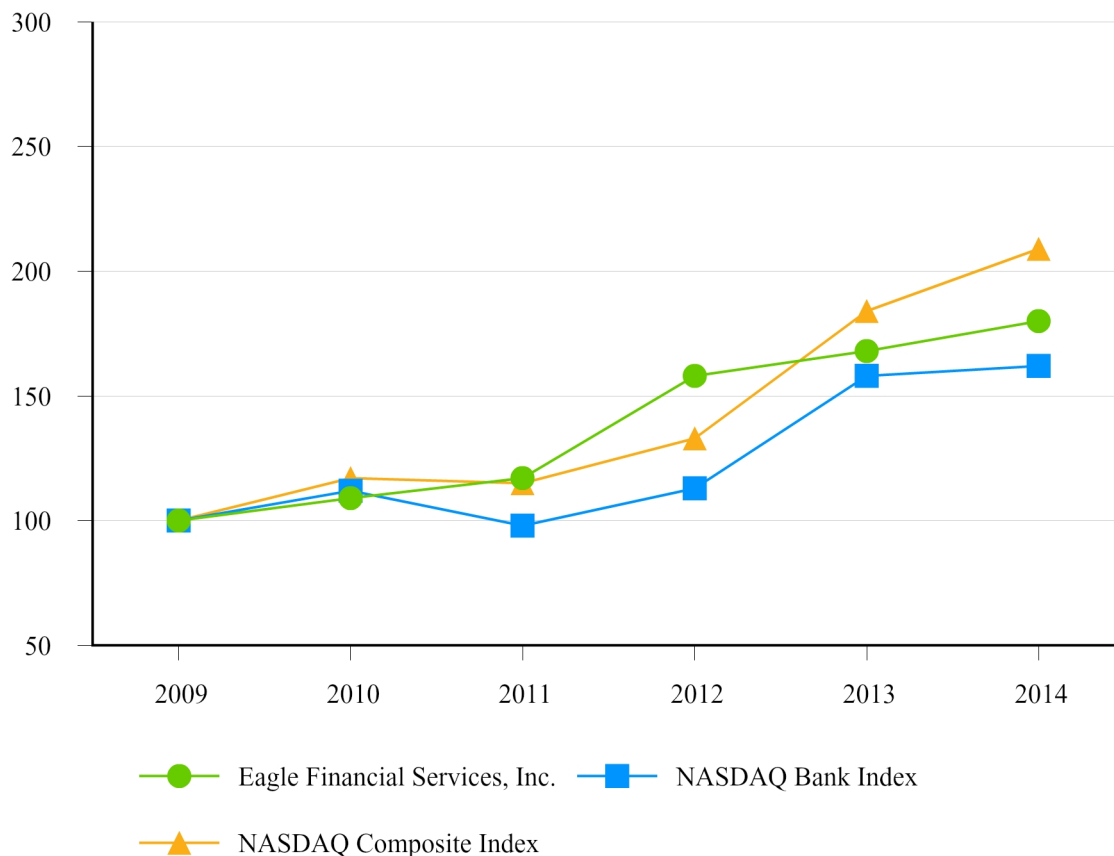
The Federal Reserve and the state of Virginia have the general authority to limit the dividends paid by insured banks if the payment is deemed an unsafe and unsound practice. Both the state of Virginia and the Federal Reserve have indicated that paying dividends that deplete a bank’s capital base to an inadequate level would be an unsound and unsafe banking practice. Under the Federal Reserve’s regulations, the Bank may not declare or pay any dividend in excess of its net income for the current year plus any retained net income from the prior two calendar years. The Bank may also not declare or pay a dividend without the approval of its board and two-thirds of its shareholders if the dividend would exceed its undivided profits, as reported to the Federal Reserve.

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

Stock Performance

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

	2009	2010	2011	2012	2013	2014
Eagle Financial Services, Inc.	\$ 100	\$ 109	\$ 117	\$ 158	\$ 168	\$ 180
NASDAQ Bank Index	100	112	98	113	158	162
NASDAQ Composite Index	100	117	115	133	184	209



Item 6. Selected Financial Data

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

	December 31,				
	2014	2013	2012	2010	2009
	(dollars in thousands, except per share amounts)				
Income Statement Data:					
Interest and dividend income	\$ 24,850	\$ 25,036	\$ 26,566	\$ 27,571	\$ 27,789
Interest expense	1,912	2,585	3,384	4,805	5,530
Net interest income	\$ 22,938	\$ 22,451	\$ 23,182	\$ 22,766	\$ 22,259
Provision for loan losses	350	—	1,660	3,750	6,325
Net interest income after provision for loan losses	\$ 22,588	\$ 22,451	\$ 21,522	\$ 19,016	\$ 15,934
Noninterest income	6,606	7,462	6,127	5,946	5,837
Net revenue	\$ 29,194	\$ 29,913	\$ 27,649	\$ 24,962	\$ 21,771
Noninterest expenses	19,986	20,367	18,540	19,269	17,147
Income before income taxes	\$ 9,208	\$ 9,546	\$ 9,109	\$ 5,693	\$ 4,624
Applicable income taxes	2,068	2,388	2,559	1,371	1,019
Net Income	<u>\$ 7,140</u>	<u>\$ 7,158</u>	<u>\$ 6,550</u>	<u>\$ 4,322</u>	<u>\$ 3,605</u>
Performance Ratios:					
Return on average assets	1.19%	1.23%	1.15%	0.76%	0.65%
Return on average equity	10.25%	11.04%	10.71%	7.73%	6.71%
Shareholders' equity to assets	11.67%	11.32%	10.74%	10.23%	9.63%
Dividend payout ratio	37.03%	36.02%	37.10%	54.77%	61.98%
Non-performing loans to total loans	2.28%	1.00%	0.63%	0.62%	2.05%
Non-performing assets to total assets	2.04%	1.04%	0.94%	0.86%	1.82%
Per Share Data:					
Net income, basic	\$ 2.08	\$ 2.11	\$ 1.97	\$ 1.31	\$ 1.11
Net income, diluted	2.07	2.10	1.96	1.31	1.11
Cash dividends declared	0.77	0.76	0.73	0.72	0.69
Book value	21.01	19.57	19.11	17.67	16.50
Market price	23.30	22.50	22.00	16.81	16.50
Average shares outstanding, basic	3,438,348	3,386,467	3,333,235	3,292,290	3,243,292
Average shares outstanding, diluted	3,446,818	3,397,742	3,343,212	3,299,998	3,250,868
Balance Sheet Data:					
Total securities	\$ 96,973	\$ 104,790	\$ 105,531	\$ 117,654	\$ 113,776
Total loans	469,820	444,273	418,097	410,424	408,449
Total assets	626,830	586,444	593,276	568,022	558,840
Total deposits	503,816	487,587	477,101	448,465	429,296
Shareholders' equity	73,132	66,406	63,706	58,090	53,829

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

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

GENERAL

The Company is a bank holding company which owns 100% of the stock of Bank of Clarke County (the "Bank"). Accordingly, the results of operations for the Company are dependent upon the operations of the Bank. The Bank conducts commercial banking business which consists of attracting deposits from the general public and investing those funds in commercial, consumer and real estate loans and corporate, municipal and U.S. government agency securities. The Bank's deposits are insured by the Federal Deposit Insurance Corporation to the extent permitted by law. At December 31, 2014, the Company had total assets of \$626.8 million, net loans of \$464.7 million, total deposits of \$503.8 million and shareholders' equity of \$73.1 million. The Company's net income was \$7.1 million for the year ended December 31, 2014.

MANAGEMENT'S STRATEGY

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

OPERATING STRATEGY

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

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

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

LENDING POLICIES

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

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

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

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

One-to-Four-Family Residential Real Estate Lending

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

Commercial Real Estate Lending

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

Construction and Land Development Lending

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

Commercial and Industrial Lending

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

Consumer Lending

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

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

CRITICAL ACCOUNTING POLICIES

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

The allowance for loan losses is an estimate of the losses that may be sustained in the Company's loan portfolio. As required by GAAP, the allowance for loan losses is accrued when their occurrence is probable and they can be estimated. 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 2014 Form 10-K, provides additional information related to the allowance for loan losses.

FORWARD LOOKING STATEMENTS

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

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

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

RESULTS OF OPERATIONS

Net Income

Net income for 2014 was \$7.1 million, a decrease of \$18 thousand or 0.25% over 2013's net income of \$7.2 million. Net income for 2013 increased \$608 thousand or 9.28% from 2012's net income of \$6.6 million. Diluted earnings per share were \$2.07, \$2.10, and \$1.96 for 2014, 2013, and 2012, respectively.

Return on average assets (ROA) measures how efficiently the Company uses its assets to produce net income. Some issues reflected within this efficiency include the Company's asset mix, funding sources, pricing, fee generation, and cost control. The ROA of the Company, on an annualized basis, was 1.19%, 1.23%, and 1.15% for 2014, 2013, and 2012, respectively.

Return on average equity (ROE) measures the utilization of shareholders' equity in generating net income. This measurement is affected by the same factors as ROA with consideration to how much of the Company's assets are funded by the shareholders. The ROE for the Company was 10.25%, 11.04%, and 10.71% for 2014, 2013, and 2012, respectively.

Net Interest Income

Net interest income, the difference between total interest income and total interest expense, is the Company's primary source of earnings. Net interest income was \$22.9 million for 2014, \$22.5 million for 2013, and \$23.2 million for 2012, which represents an increase of \$487 thousand or 2.17% and a decrease of \$731 thousand or 3.15% for 2014 and 2013, respectively. Net interest income is derived from the volume of earning assets and the rates earned on those assets as compared to the cost of funds. Total interest income was \$24.9 million for 2014, \$25.0 million for 2013, and \$26.6 million for 2012, which represents a decrease of \$186 thousand or 0.74% and \$1.6 million or 5.76% for 2014 and 2013, respectively. Total interest expense was \$1.9 million for 2014, \$2.6 million for 2013, and \$3.4 million for 2012, which represents a decrease of \$673 thousand or 26.03% and \$799 thousand or 23.61% in 2014 and 2013, respectively. The decreases in total interest income and total interest expense during 2014 are driven mainly by the interest rate environment. Refer to the table titled "Volume and Rate Analysis" for further detail on these decreases.

The table titled "Average Balances, Income and Expenses, Yields and Rates" displays the composition of interest earnings assets and interest bearing liabilities and their respective yields and rates for the years ended December 31, 2014, 2013, and 2012.

The net interest margin was 4.20% for 2014, 4.24% for 2013, and 4.47% for 2012. 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 2014, 2013, and 2012. The table titled "Tax-Equivalent Net Interest Income" reconciles net interest income to tax-equivalent net interest income, which is not a measurement under GAAP, for the years ended December 31, 2014, 2013, and 2012.

Average Balances, Income and Expenses, Yields and Rates

(dollars in thousands)

	December 31, 2014			December 31, 2013			December 31, 2012		
	Average Balances	Interest Income/Expense	Average Yield/Rate	Average Balances	Interest Income/Expense	Average Yield/Rate	Average Balances	Interest Income/Expense	Average Yield/Rate
Assets:									
Securities:									
Taxable	\$ 68,119	\$ 2,047	3.01%	\$ 72,630	\$ 2,242	3.09%	\$ 70,134	\$ 2,571	3.67%
Tax-Exempt (1)	33,652	1,661	4.94%	36,692	1,881	5.13%	39,281	2,095	5.33%
Total Securities	\$ 101,771	\$ 3,708	3.64%	\$ 109,322	\$ 4,123	3.77%	\$ 109,415	\$ 4,666	4.26%
Loans:									
Taxable	449,247	21,477	4.78%	422,692	21,352	5.05%	413,281	22,387	5.42%
Non-accrual	6,811	—	—%	2,921	—	—%	2,731	—	—%
Tax-Exempt (1)	5,789	330	5.70%	4,423	269	6.08%	4,786	306	6.39%
Total Loans	\$ 461,847	\$ 21,807	4.72%	\$ 430,036	\$ 21,621	5.03%	\$ 420,798	\$ 22,693	5.39%
Federal funds sold	—	—	—%	—	—	—%	92	—	—%
Interest-bearing deposits in other banks	6,075	12	0.20%	10,048	23	0.23%	9,420	23	0.24%
Total earning assets	\$ 562,882	\$ 25,527	4.54%	\$ 546,485	\$ 25,767	4.72%	\$ 536,994	\$ 27,382	5.10%
Allowance for loan losses	(5,839)			(6,957)			(8,393)		
Total non-earning assets	43,008			40,573			39,698		
Total assets	\$ 600,051			\$ 580,101			\$ 568,299		
Liabilities and Shareholders' Equity:									
Interest-bearing deposits:									
NOW accounts	\$ 82,821	\$ 88	0.11%	\$ 83,889	\$ 103	0.12%	\$ 80,500	\$ 140	0.17%
Money market accounts	94,650	108	0.11%	87,809	120	0.14%	84,241	210	0.25%
Savings accounts	67,515	35	0.05%	59,114	30	0.05%	52,635	39	0.07%
Time deposits:									
\$100,000 and more	35,341	181	0.51%	38,232	241	0.63%	48,065	380	0.79%
Less than \$100,000	61,136	512	0.84%	65,900	648	0.98%	71,810	817	1.14%
Total interest-bearing deposits	\$ 341,463	\$ 924	0.27%	\$ 334,944	\$ 1,142	0.34%	\$ 337,251	\$ 1,586	0.47%
Federal funds purchased and securities sold under agreements to repurchase	1,865	20	1.07%	1,064	31	2.91%	10,174	360	3.54%
Federal Home Loan Bank advances	28,818	650	2.26%	32,223	1,094	3.40%	32,960	1,120	3.40%
Trust preferred capital notes	7,217	318	4.41%	7,217	318	4.41%	7,217	318	4.41%
Total interest-bearing liabilities	\$ 379,363	\$ 1,912	0.50%	\$ 375,448	\$ 2,585	0.69%	\$ 387,602	\$ 3,384	0.87%
Noninterest-bearing liabilities:									
Demand deposits	149,026			136,242			115,667		
Other Liabilities	1,981			3,581			3,864		
Total liabilities	\$ 530,370			\$ 515,271			\$ 507,133		
Shareholders' equity	69,681			64,830			61,166		
Total liabilities and shareholders' equity	\$ 600,051			\$ 580,101			\$ 568,299		
Net interest income		\$ 23,615			\$ 23,182			\$ 23,998	
Net interest spread			4.04%			4.03%			4.23%
Interest expense as a percent of average earning assets			0.34%			0.47%			0.63%
Net interest margin			4.20%			4.24%			4.47%

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

Tax-Equivalent Net Interest Income

(dollars in thousands)

	December 31,		
	2014	2013	2012
GAAP Financial Measurements:			
Interest Income - Loans	\$ 21,695	\$ 21,530	\$ 22,589
Interest Income - Securities and Other Interest-Earnings Assets	3,155	3,506	3,977
Interest Expense - Deposits	924	1,142	1,586
Interest Expense - Other Borrowings	988	1,443	1,798
Total Net Interest Income	\$ 22,938	\$ 22,451	\$ 23,182
Non-GAAP Financial Measurements:			
Add: Tax Benefit on Tax-Exempt Interest Income - Loans	\$ 112	\$ 92	\$ 104
Add: Tax Benefit on Tax-Exempt Interest Income - Securities and Other Interest-Earnings Assets	565	639	712
Total Tax Benefit on Tax-Exempt Interest Income	\$ 677	\$ 731	\$ 816
Tax-Equivalent Net Interest Income	\$ 23,615	\$ 23,182	\$ 23,998

The tax-equivalent yield on earning assets decreased 18 basis points from 2013 to 2014 and 38 basis points from 2012 to 2013. The tax-equivalent yield on securities decreased 13 basis points from 2013 to 2014 and 49 basis points from 2012 to 2013. The tax-equivalent yield on loans decreased 31 basis points from 2013 to 2014 and 36 basis points from 2012 to 2013. The decrease in the yield on earning assets, securities, and the loan portfolio was primarily a result of the low interest rate environment that extended through 2014.

The average rate on interest-bearing liabilities decreased 19 basis points from 2013 to 2014 and 18 basis points from 2012 to 2013. These changes were caused primarily by management of the deposit pricing and product mix, prepayment of one FHLB advance during 2013, and the continued low rate environment. An intentional shift in the product mix during 2014 was planned and achieved to move from time deposits to non-maturity deposits. The average rate on total interest-bearing deposits decreased 7 basis points from 2013 to 2014 and 13 basis points from 2012 to 2013. In general, deposit pricing is done in response to monetary policy actions and yield curve changes. Local competition for funds affects the cost of time deposits, which are primarily comprised of certificates of deposit. The Company issues brokered certificates of deposit as a substitute for offering promotional certificates of deposit when their rates are lower. The rates on brokered certificates of deposit are usually comparable with other wholesale funding sources and these funds can be gathered more efficiently without causing existing deposits to reprice. The Company prefers to rely most heavily on non-maturity deposits, which include NOW accounts, money market accounts, and savings accounts. The average balance of non-maturity interest-bearing deposits increased \$14.2 million or 6.14% from \$230.8 million during 2013 to \$245.0 million in 2014 and \$13.4 million or 6.18% from \$217.4 million at December 31, 2012 during 2013. Changes in the average rate on interest-bearing liabilities can also be affected by the pricing on other sources of funds, namely borrowings. The Company from time to time will utilize overnight borrowings in the form of federal funds purchased and retail repurchase agreements. The Company also borrows funds for a longer term through wholesale repurchase agreements, which require marketable securities as collateral. The average rate on these borrowings decreased 184 basis points from 2013 to 2014 and 63 basis points from 2012 to 2013. The rate on wholesale repurchase agreements, which matured in January 2013, was fixed at 3.54%, while the cost of federal funds purchased is affected by the Federal Reserve's changes in the federal funds target rate, which remained at 0.25% during 2014. The Company has not borrowed funds through retail repurchase agreements since June 2011. Finally, the Company borrows from the Federal Home Loan Bank through short and long term advances. The average rate on FHLB advances decreased 114 basis points from 2013 to 2014 and remained stable from 2012 to 2013. The average balance on FHLB advances decreased \$3.4 million during 2014 and decreased \$737 thousand during 2013.

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

The table titled "Volume and Rate Analysis" provides information about the effect of changes in financial assets and liabilities and changes in rates on net interest income. Non-accruing loans are excluded from the average outstanding loans. Tax-equivalent net interest income increased \$433 thousand during 2014. The increase in tax-equivalent net interest income during 2014 is comprised of an increase due to volume of \$774 thousand and a decrease due to rate of \$341 thousand. The change in tax-equivalent net interest income during 2014 was primarily affected by low rates on deposits, Federal Home Loan Bank advances, and taxable loans.

Volume and Rate Analysis (Tax-Equivalent Basis)

(dollars in thousands)

	2014 vs 2013 Increase (Decrease) Due to Changes in:			2013 vs 2012 Increase (Decrease) Due to Changes in:		
	Volume	Rate	Total	Volume	Rate	Total
Earning Assets:						
Securities:						
Taxable	\$ (138)	\$ (57)	\$ (195)	\$ 96	\$ (425)	\$ (329)
Tax-exempt	(152)	(68)	(220)	(136)	(78)	(214)
Loans:						
Taxable	839	(714)	125	518	(1,553)	(1,035)
Tax-exempt	76	(15)	61	(23)	(14)	(37)
Federal funds sold	—	—	—	—	—	—
Interest-bearing deposits in other banks	(8)	(3)	(11)	—	—	—
Total earning assets	\$ 617	\$ (857)	\$ (240)	\$ 455	\$ (2,070)	\$ (1,615)
Interest-Bearing Liabilities:						
NOW accounts	\$ (2)	\$ (13)	\$ (15)	\$ 6	\$ (43)	\$ (37)
Money market accounts	7	(19)	(12)	10	(100)	(90)
Savings accounts	5	—	5	7	(16)	(9)
Time deposits:						
\$100,000 and more	(17)	(43)	(60)	(70)	(69)	(139)
Less than \$100,000	(46)	(90)	(136)	(62)	(107)	(169)
Total interest-bearing deposits	\$ (53)	\$ (165)	\$ (218)	\$ (109)	\$ (335)	\$ (444)
Federal funds purchased and securities sold under agreements to repurchase	\$ 2	\$ (13)	\$ (11)	\$ (335)	\$ 6	\$ (329)
Federal Home Loan Bank advances	(106)	(338)	(444)	(26)	—	(26)
Trust preferred capital notes	—	—	—	—	—	—
Total interest-bearing liabilities	\$ (157)	\$ (516)	\$ (673)	\$ (470)	\$ (329)	\$ (799)
Change in net interest income	\$ 774	\$ (341)	\$ 433	\$ 925	\$ (1,741)	\$ (816)

Provision for Loan Losses

The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses as discussed within the Critical Accounting Policies section above. The provision for loan losses was \$350 thousand for 2014, zero for 2013, and \$1.7 million for 2012. Changes in the amount of provision for loan losses during each period reflect the results of the Bank's analysis used to determine the adequacy of the allowance for loan losses. The lower provision for loan losses in 2014 and 2013, compared to 2012, reflects lower specific reserves on remaining impaired loans as well as a lower net charge off amounts. The Company is committed to maintaining an allowance that adequately reflects the risk inherent in the loan portfolio. This commitment is more fully discussed in the "Asset Quality" section.

Noninterest Income

Total noninterest income was \$6.6 million, \$7.5 million, and \$6.1 million during 2014, 2013, and 2012, respectively. This represents a decrease of \$856 thousand or 11.47% for 2014 and an increase of \$1.4 million or 21.79% for 2013. Management reviews the activities which generate noninterest income on an ongoing basis.

The following table provides the components of noninterest income for the twelve months ended December 31, 2014, 2013, and 2012, which are included within the respective Consolidated Statements of Income headings. The following paragraphs provide information about activities which are included within the respective Consolidated Statements of Income headings.

(dollars in thousands)	December 31,							
	2014	2013	\$ Change	% Change	2013	2012	\$ Change	% Change
Income from fiduciary activities	\$ 1,162	\$ 1,186	\$ (24)	(2.02)%	\$ 1,186	\$ 963	\$ 223	23.16 %
Service charges on deposit accounts	1,323	1,453	(130)	(8.95)%	1,453	1,509	(56)	(3.71)%
Other service charges and fees	2,995	3,864	(869)	(22.49)%	3,864	3,404	460	13.51 %
Gain (loss) on the sale of bank premises and equipment	(14)	(1)	(13)	NM	(1)	—	(1)	NM
Gain on sale of securities	990	465	525	NM	465	45	420	NM
Other operating income	150	495	(345)	(69.70)%	495	206	289	140.29 %
Total noninterest income	6,606	7,462	(856)	(11.47)%	7,462	6,127	1,335	21.79 %

NM - Not Meaningful

Variances that the Company believes require explanation are discussed below.

Income from fiduciary activities, generated by trust services offered through Eagle Investment Group, increased by \$223 thousand or 23.16% for 2013. The amount of income from fiduciary activities is determined by the number of active accounts and total assets under management. Also, income can fluctuate due to the number of estates settled within any period. During the first quarter of 2013, the Company determined that it had under-accrued trust fees receivable during 2011 and 2012. An adjustment was made in the first quarter of 2013 to increase the trust fees receivable account and increase the corresponding income from fiduciary activities.

The amount of other services charges and fees is comprised primarily of commissions from the sale of non-deposit investment products, fees received from the Bank's credit card program, fees generated from the Bank's ATM/debit card programs, and fees generated from the origination of mortgage loans for the secondary market. Other service charges and fees decreased by \$869 thousand or 22.49% for 2014. Other service charges and fees increased by \$460 thousand or 13.51% for 2013. In April of 2013, the Company received a signing bonus of \$121 thousand from its current debit card vendor for extending its contract and remaining exclusive to this provider. In addition, in 2013, the Company recorded the sale of the Bank's merchant processing business. The sale of the merchant portfolio resulted in a net gain of \$399 thousand. Total proceeds from the transaction of \$450 thousand are reflected in other service charges and fees while broker, legal and other related expenses are reflected in non-interest expense. These two transactions were a large contributor to the overall increase during 2013 and the overall decrease during 2014. During 2014, these decreases in other service charges and fees were augmented by a decrease of \$155 thousand or 54.20% in fees generated from the origination of mortgage loans for the secondary market. This decrease is due to decreased volume in this product for 2014.

In 2014, the Company sold \$8.5 million in available for sale securities for a net gain of \$990 thousand. In 2013, the Company sold \$4.0 million in available for sale securities for a net gain of \$465 thousand. In 2012, the Company sold \$3.4 million in available for sale securities for a net gain of \$45 thousand. No impairment charges were recorded during 2014, 2013, or 2012.

Other operating income decreased \$345 thousand or 69.70% during 2014. Other operating income increased \$289 thousand or 140.29% during 2013. During 2013, the Company recorded \$254 thousand of income related to the proceeds received from a bank owned life insurance policy, which was the majority of the 2014 decrease and 2013 increase to other operating income.

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

Noninterest Expenses

Total noninterest expenses were \$20.0 million, \$20.4 million, and \$18.5 million during 2014, 2013, and 2012, respectively. This represents a decrease of \$381 thousand or 1.87% during 2014 and an increase of \$1.9 million or 9.85% during 2013. The efficiency ratio of the Company was 67.59%, 65.36%, and 61.06% for 2014, 2013, and 2012, respectively. The efficiency ratio is calculated by dividing total noninterest expenses by the sum of tax-equivalent net interest income and total noninterest income, excluding certain non-recurring gains and losses. A reconciliation of tax-equivalent net interest income, which is not a measurement under GAAP, to net interest income is presented within the *Net Interest Income* section above. The following paragraphs provide information about expenses which are included within the respective Consolidated Statements of Income headings.

(dollars in thousands)	December 31,							
	2014	2013	\$ Change	% Change	2013	2012	\$ Change	% Change
Salaries and employee benefits	\$ 11,427	\$ 11,451	\$ (24)	(0.21)%	\$ 11,451	\$ 10,634	\$ 817	7.68 %
Occupancy expenses	1,280	1,291	(11)	(0.85)%	1,291	1,147	144	12.55 %
Equipment expenses	720	666	54	8.11 %	666	665	1	0.15 %
Advertising and marketing expenses	571	548	23	4.20 %	548	470	78	16.60 %
Stationery and supplies	307	274	33	12.04 %	274	289	(15)	(5.19)%
ATM network fees	712	616	96	15.58 %	616	528	88	16.67 %
Other real estate owned expense	27	40	(13)	(32.50)%	40	362	(322)	(88.95)%
(Gain) loss on the sale of other real estate owned	(82)	140	(222)	NM	140	(13)	153	NM
FDIC assessment	357	375	(18)	(4.80)%	375	292	83	28.42 %
Computer software expense	872	664	208	31.33 %	664	463	201	43.41 %
Bank franchise tax	466	407	59	14.50 %	407	383	24	6.27 %
Professional fees	988	1,013	(25)	(2.47)%	1,013	1,072	(59)	(5.50)%
Other bank services charges	73	695	(622)	(89.50)%	695	79	616	779.75 %
Other operating expenses	2,268	2,187	81	3.70 %	2,187	2,169	18	0.83 %
Total noninterest expenses	\$ 19,986	\$ 20,367	\$ (381)	(1.87)%	\$ 20,367	\$ 18,540	\$ 1,827	9.85 %

NM - Not Meaningful

Variances that the Company believes require explanation are discussed below.

Salaries and employee benefits increased \$817 thousand or 7.68% during 2013. This increase can be attributed to several factors including annual salary increases and salary expenses related to the Purcellville branch which opened in 2013. Also, in 2013, the Company began an accrual for hourly employees due to being paid one week in arrears, which amounted to a \$70 thousand expense.

Occupancy expenses increased \$144 thousand or 12.55% during 2013. Occupancy expenses for the Purcellville branch, which opened in May 2013, were approximately \$150 thousand.

Advertising and marketing expenses increased \$78 thousand or 16.60% during 2013. This category contains numerous expense types such as advertising, public relations, business development, and charitable contributions. The annual budgeted amount of advertising and marketing expenses is directly related to the Company's growth in assets. The total amount of advertising and marketing expenses varies based on planned events and advertising campaigns. Expenses are allocated in a manner which focuses on effectively reaching existing and potential customers within the market and contributing to the community. Advertising expenses were higher during 2013 due to the opening of the new Purcellville branch and continue to remain at a higher amount during 2014 due to advertising related to additional branches opening in 2015.

ATM network fees increased \$96 thousand or 15.58% during 2014 and increased \$88 thousand or 16.67% during 2013. ATM network fees fluctuate based on the usage of ATM and debit cards. This expense has increased similarly to increases in deposit accounts.

Other real estate owned expenses decreased \$322 thousand or 88.95% during 2013. This fluctuation is due mainly to a valuation allowance of \$283 thousand that was established during 2012. No valuation allowances were established during 2014 and 2013.

FDIC assessments increased \$83 thousand or 28.42% during 2013. On December 30 2009, the Company prepaid their estimated quarterly FDIC assessments of \$2.3 million for 2010, 2011, and 2012. The remaining prepaid FDIC balance of \$435 thousand was refunded to the Company on June 28, 2013. During the second quarter of 2012, the Company determined that it had expensed too much of its remaining prepaid FDIC insurance balance during the period of October 1, 2011 through March 31, 2012 and as a result made a \$174 thousand adjustment to increase the prepaid balance and decrease the corresponding expense.

Computer software expense increased \$208 thousand or 31.33% during 2014 and increased \$201 thousand or 43.41% during 2013. As the Company grows, the number of branches increase, and regulations increase, the Company has had to invest in additional software products causing expenses to increase.

Bank franchise tax increased \$59 thousand or 14.50% during 2014. The bank franchise tax calculation is driven largely by the amount of the Bank's capital at January 1st of each year. As this amount has increased from year to year, the amount of tax has also increased.

Other bank service charges decreased \$622 thousand or 89.50% during 2014. Other bank service charges increased \$616 thousand or 779.75% during 2013. Noninterest expense was negatively impacted in 2013 by the Company's election to prepay a \$10.0 million outstanding advance with the Federal Home Loan Bank of Atlanta. A \$612 thousand prepayment fee was incurred by the Company in December 2013 in conjunction with the repayment of the advance.

Income Taxes

Income tax expense was \$2.1 million, \$2.4 million, and \$2.6 million for the years ended December 31, 2014, 2013, and 2012, respectively. The change in income tax expense can be attributed to changes in taxable earnings at the federal statutory income tax rate of 34%. These amounts correspond to an effective tax rate of 22.46%, 25.02%, and 28.09% for 2014, 2013, and 2012, respectively. Note 9 to the Consolidated Financial Statements provides a reconciliation between income tax expense computed using the federal statutory income tax rate and the Company's actual income tax expense during 2014, 2013, and 2012.

FINANCIAL CONDITION

Assets, Liabilities and Shareholders' Equity

The Company's total assets were \$626.8 million at December 31, 2014, an increase of \$40.4 million or 6.89% from \$586.4 million at December 31, 2013. Securities decreased \$8.4 million or 8.22% from 2013 to 2014. Loans, net of allowance for loan losses, increased by \$26.0 million or 5.92% from 2013 to 2014. Total liabilities were \$553.7 million at December 31, 2014, compared to \$520.0 million at December 31, 2013. Total shareholders' equity at year end 2014 and 2013 was \$73.1 million and \$66.4 million, respectively.

Securities

Total securities at December 31, 2014 were \$94.2 million as compared to \$102.6 million as of December 31, 2013, which represents a decrease of \$8.4 million or 8.22% during 2014. The table titled "Securities Portfolio" shows the carrying value of securities at December 31, 2014, 2013, and 2012. The Company purchased \$8.7 million in securities during 2014. This amount includes \$3.0 million or 34.76% in obligations of U.S. government corporations and agencies, \$3.1 million or 35.86% in mortgage-backed securities, \$1.8 million or 20.63% in obligations of states and political subdivisions, and \$761 thousand or 8.76% in corporate securities. The Company had \$10.8 million in maturities and principal repayments on securities during 2014. This amount includes \$1.0 million or 9.23% in obligations of U.S. government corporations and agencies, \$2.7 million or 25.12% in mortgage-backed securities, \$5.1 million or 47.20% in obligations of states and political subdivisions, and \$2.0 million or 18.45% in corporate securities. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity as of December 31, 2014. Note 2 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio as of December 31, 2014 and 2013.

Securities Portfolio

(dollars in thousands)

	December 31,		
	2014	2013	2012
Securities available for sale:			
Obligations of U.S. government corporations and agencies	\$ 37,211	\$ 34,744	\$ 23,692
Mortgage-backed securities	15,779	15,197	22,207
Obligations of states and political subdivisions	40,410	43,116	43,501
Corporate securities	765	8,423	11,156
Equity securities	—	1,118	2,198
	<u>\$ 94,165</u>	<u>\$ 102,598</u>	<u>\$ 102,754</u>

The ability to dispose of available for sale securities prior to maturity provides management more options to react to future rate changes and provides more liquidity, when needed, to meet short-term obligations. The Company had a net unrealized gain on available for sale securities of \$2.2 million and \$831 thousand at December 31, 2014 and 2013, respectively. Unrealized gains or losses on available for sale securities are reported within shareholders' equity, net of the related deferred tax effect, as accumulated other comprehensive income.

The table titled “Maturity Distribution and Yields of Securities” shows the maturity period and average yield for the different types of securities in the portfolio at December 31, 2014. Although mortgage-backed securities have definitive maturities, they provide monthly principal curtailments which can be reinvested at a prevailing rate and for a different term.

Maturity Distribution and Yields of Securities

(dollars in thousands)

	December 31, 2014									
	Due in one year or less		Due after 1 through 5 years		Due after 5 through 10 years		Due after 10 years and Equity Securities		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available for sale:										
Obligations of U.S. government corporations and agencies	\$ 2,026	2.06%	\$ 15,222	1.68%	\$ 18,005	2.31%	\$ 1,958	3.36%	\$ 37,211	2.10%
Mortgage-backed securities	—	—%	141	4.37%	3,483	2.02%	12,155	3.01%	15,779	2.80%
Corporate securities	—	—%	—	—%	—	—%	765	1.62%	765	1.62%
Obligations of states and political subdivisions, taxable	—	—%	2,858	2.68%	3,498	4.48%	1,533	5.13%	7,889	3.94%
Equity securities	—	—%	—	—%	—	—%	—	—%	—	—%
Total taxable	\$ 2,026	2.06%	\$ 18,221	1.86%	\$ 24,986	2.56%	\$ 16,411	3.18%	\$ 61,644	2.50%
Obligations of states and political subdivisions, tax-exempt (1)	1,686	3.83%	9,825	2.99%	18,408	3.23%	2,602	4.64%	32,521	3.30%
Total	\$ 3,712	2.87%	\$ 28,046	2.25%	\$ 43,394	2.84%	\$ 19,013	3.38%	\$ 94,165	2.77%

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

Loan Portfolio

The Company’s primary use of funds is supporting lending activities from which it derives the greatest amount of interest income. Gross loans were \$469.8 million and \$444.3 million at December 31, 2014 and 2013, respectively. This represents an increase of \$25.5 million or 5.75% for 2014. The ratio of loans to deposits increased during the year from 91.12% to 92.24% at December 31, 2013 and December 31, 2014, respectively. The table titled “Loan Portfolio” shows the composition of the loan portfolio over the last five years.

Loan Portfolio

(dollars in thousands)

	December 31,				
	2014	2013	2012	2011	2010
Loans secured by real estate:					
Construction and land development	\$ 25,887	\$ 27,047	\$ 30,846	\$ 31,579	\$ 31,560
Secured by farmland	10,602	9,886	7,030	3,390	4,332
Secured by 1-4 family residential properties	224,694	218,633	214,619	212,638	207,671
Multifamily	3,016	2,850	2,808	4,517	4,908
Commercial	161,299	148,166	124,382	118,043	116,381
Loans to farmers	957	1,321	1,525	1,910	1,293
Commercial and industrial loans	28,132	20,865	21,640	22,866	24,449
Consumer installment loans	13,874	13,785	13,307	13,185	14,518
All other loans	1,359	1,720	1,940	2,296	3,337
Total loans	\$ 469,820	\$ 444,273	\$ 418,097	\$ 410,424	\$ 408,449

Loans secured by real estate were \$425.5 million or 90.57% and \$406.6 million or 91.52% of total loans at December 31, 2014 and 2013, respectively. This represents an increase of \$18.9 million or 4.65% for 2014. Consumer installment loans were \$13.9 million or 2.95% and \$13.8 million or 3.10% of total loans at December 31, 2014 and 2013, respectively. This represents an increase of \$89 thousand or 0.65% for 2014. Commercial and industrial loans were \$28.1 million or 5.99% and \$20.9 million or 4.70% of total loans at December 31, 2014 and 2013. This represents an increase of \$7.2 million or 34.83% for 2014.

The table titled “Maturity Schedule of Selected Loans” shows the different loan categories and the period during which they mature. For loans maturing in more than one year, the table also shows a breakdown between fixed rate loans and floating rate loans. The table indicates that \$349.8 million or 74.45% of the loan portfolio matures within five years. The floating rate loans maturing after five years are primarily comprised of home equity lines of credit.

Maturity Schedule of Selected Loans

(dollars in thousands)

	December 31, 2014			
	Within 1 Year	After 1 Year Within 5 Years	After 5 Years	Total
Loans secured by real estate:				
Construction and land development	\$ 16,455	\$ 6,754	\$ 2,678	\$ 25,887
Secured by farmland	2,021	5,526	3,055	10,602
Secured by 1-4 family residential properties	32,719	126,509	65,466	224,694
Multifamily	615	1,825	576	3,016
Commercial	23,361	95,601	42,337	161,299
Loans to farmers	207	750	—	957
Commercial and industrial loans	14,021	8,572	5,539	28,132
Consumer installment loans	1,095	12,507	272	13,874
All other loans	—	1,264	95	1,359
	<u>\$ 90,494</u>	<u>\$ 259,308</u>	<u>\$ 120,018</u>	<u>\$ 469,820</u>
For maturities over one year:				
Floating rate loans		\$ 12,370	\$ 23,183	\$ 35,553
Fixed rate loans		246,938	96,835	343,773
		<u>\$ 259,308</u>	<u>\$ 120,018</u>	<u>\$ 379,326</u>

Asset Quality

The Company has policies and procedures designed to control credit risk and to maintain the quality of its loan portfolio. These include underwriting standards for new originations and ongoing monitoring and reporting of asset quality and adequacy of the allowance for loan losses. There were \$12.8 million in total non-performing assets, which consist of nonaccrual loans, foreclosed property, and repossessed assets at December 31, 2014. This is an increase of \$6.7 million when compared to the December 31, 2013 balance of \$6.1 million. This increase resulted mostly from the increase in nonaccrual loans as discussed below.

Nonaccrual loans were \$10.7 million at December 31, 2014 and \$4.4 million at 2013. The gross amount of interest income that would have been recognized on nonaccrual loans was \$108 thousand for 2014 and \$129 thousand for 2013. None of this interest income was included in net income for 2014 or 2013. A total of 31 loans were placed in nonaccrual during 2014. The majority of these loans (20) had balances of less than \$250 thousand. Eleven loans with balances exceeding \$250 thousand were added to nonaccrual during 2014 totaling \$5.2 million. In addition, six loans totaling \$408 thousand were removed from nonaccrual status during 2014. Of the \$6.3 increase in nonaccrual loans between December 31, 2013 and December 31, 2014, the majority of the increase was due to four relationships totaling \$4.3 million. These relationships were identified as impaired in prior periods and were subsequently placed on nonaccrual during 2014 due to further deterioration. Management evaluates the financial condition of these borrowers and the value of any collateral on these loans. The results of these evaluations are used to estimate the amount of losses which may be realized on the disposition of these nonaccrual loans. Nonaccrual loans that were evaluated for impairment at December 31, 2014 totaled \$10.7 million and had \$431 thousand in specific allocations.

Foreclosed property increased to \$2.1 million at December 31, 2014, compared to \$1.6 million at December 31, 2013. Five foreclosed properties were sold during 2014, while nine foreclosed properties were acquired. When the property is sold, the difference between the amount of other real estate owned and the settlement proceeds is recognized as a gain or loss on the sale of other real estate owned. A net gain of \$82 thousand was recognized on the sale of other real estate owned during 2014. A net loss of \$140 thousand was recognized on the sale of other real estate owned during 2013.

Total loans past due 90 days or more and still accruing interest were \$6 thousand or 0.00%, \$11 thousand or 0.00%, and \$208 thousand or 0.05% of total loans at December 31, 2014, 2013, and 2012, respectively. The loans past due 90 days or more and still accruing interest are well secured and in the process of collection; therefore, they are not classified as nonaccrual.

Nonperforming and Other Assets

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

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

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

In addition, the Company may, under certain circumstances, restructure loans in troubled debt restructurings as a concession to a borrower when the borrower is experiencing financial distress. Formal, standardized loan restructuring programs are not utilized by the Company. Each loan considered for restructuring is evaluated based on customer circumstances and may include modifications to one or more loan provisions. Such restructured loans are included in impaired loans. At December 31, 2014, 2013, 2012, 2011, and 2010, the Company had \$7.8 million, \$6.4 million, \$8.2 million, \$10.7 million, and \$8.5 million in restructured loans, respectively.

Nonperforming Assets (dollars in thousands)

	December 31,				
	2014	2013	2012	2011	2010
Nonaccrual loans	\$ 10,706	\$ 4,412	\$ 2,414	\$ 2,449	\$ 8,377
Other real estate owned and repossessed assets	2,109	1,646	2,934	2,423	1,805
Total nonperforming assets	\$ 12,815	\$ 6,058	\$ 5,348	\$ 4,872	\$ 10,182
Loans past due 90 days and accruing interest	\$ 6	\$ 11	\$ 208	\$ 94	\$ 10
Allowance for loan losses to nonperforming assets	40%	91%	123%	179%	70%
Non-performing assets to period end loans and other real estate owned	2.72%	1.36%	1.27%	1.18%	2.48%

Other potential problem loans are defined as performing loans that possess certain risks that management has identified that could result in the loans not being repaid in accordance with their terms. Accordingly, these loans are risk rated at a level of substandard or lower. At December 31, 2014, other potential problem loans totaled \$5.9 million. Of the total other potential problem loans, \$5.9 million or 100.00% are currently considered impaired and are disclosed in Note 4 to the Consolidated Financial Statements.

Allowance for Loan Losses

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

Charged-off loans were \$1.5 million, \$1.3 million, and \$4.2 million for 2014, 2013, and 2012, respectively. Recoveries were \$725 thousand, \$233 thousand, and \$337 thousand for 2014, 2013, and 2012, respectively. Net charge-offs were \$758 thousand, \$1.1 million, and \$3.8 million for 2014, 2013, and 2012, respectively. This represents a decrease in net charge-offs of \$331 thousand or 30.39% for 2014 and a decrease of \$2.7 million or 71.54% for 2013. The allowance for loan losses as a percentage of loans was 1.08%, 1.24%, and 1.57% at the end of 2014, 2013, and 2012, respectively. The decreases in allowance for loan losses as a percentage of total loans from December 31, 2013 to December 31, 2014 is primarily due to obtaining updated appraisals for collateral-dependent impaired loans, which resulted in an overall decrease in specific reserves in the allowance for loan losses during 2014. The allowance for loan losses at year-end covered net charge-offs during the year by 6.70 times for 2014, 5.04 times for 2013, and 1.72 times for 2012. The ratio of net charge-offs to average loans was 0.16% for 2014, 0.25% for 2013, and 0.91% for 2012.

The provision for loan losses for the year ended December 31, 2014 was \$350 thousand, compared to zero and \$1.7 million for the years ended December 31, 2013 and 2012, respectively. The higher provision for loan losses compared to last year reflects a higher balance in impaired loans as well as non-performing assets. Additional provisioning is also necessary as the loan portfolio grows.

The table titled “Allocation of Allowance for Loan Losses” shows the amount of the allowance for loan losses which is allocated to the indicated loan categories, along with that category’s percentage of total loans, at December 31, 2014, 2013, 2012, 2011, and 2010. The amount of allowance for loan losses allocated to each loan category is based on the amount delinquent loans in that loan category, the status of nonperforming assets in that loan category, the historical losses for that loan category, and the financial condition of certain borrowers whose financial condition is monitored on a periodic basis. Management believes that the allowance for loan losses is adequate based on the loan portfolio’s current risk characteristics.

Analysis of Allowance for Loan Losses

(dollars in thousands)

	December 31,				
	2014	2013	2012	2011	2010
Balance, beginning of period	\$ 5,488	\$ 6,577	\$ 8,743	\$ 7,111	\$ 5,970
Loans charged-off:					
Commercial, financial and agricultural	—	403	207	596	1,077
Real estate-construction and land development	482	20	1,313	710	2,917
Real estate-mortgage	891	796	2,499	1,204	1,239
Consumer	110	103	144	456	242
Total loans charged off	<u>\$ 1,483</u>	<u>\$ 1,322</u>	<u>\$ 4,163</u>	<u>\$ 2,966</u>	<u>\$ 5,475</u>
Recoveries:					
Commercial, financial and agricultural	\$ 164	\$ 47	\$ 36	\$ 137	\$ 72
Real estate-construction and land development	26	5	4	5	—
Real estate-mortgage	444	116	213	299	102
Consumer	91	65	84	407	117
Total recoveries	<u>\$ 725</u>	<u>\$ 233</u>	<u>\$ 337</u>	<u>\$ 848</u>	<u>\$ 291</u>
Net charge-offs	758	1,089	3,826	2,118	5,184
Provision for loan losses	350	—	1,660	3,750	6,325
Balance, end of period	<u>\$ 5,080</u>	<u>\$ 5,488</u>	<u>\$ 6,577</u>	<u>\$ 8,743</u>	<u>\$ 7,111</u>
Ratio of allowance for loan losses to loans outstanding at period end	1.08%	1.24%	1.57%	2.13%	1.74%
Ratio of net charge offs to average loans outstanding during the period	0.16%	0.25%	0.91%	0.52%	1.27%

Allocation of Allowance for Loan Losses

(dollars in thousands)

	Commercial, Financial, and Agricultural		Real Estate Construction		Real Estate Mortgage		Consumer and Other Loans	
	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Category to Total Loans
December 31, 2014	\$ 464	6.0%	\$ 951	7.8%	\$ 3,324	82.8%	\$ 145	3.4%
December 31, 2013	555	4.7%	1,032	8.3%	3,562	83.2%	184	3.8%
December 31, 2012	880	5.2%	1,280	9.0%	4,002	81.8%	229	4.0%
December 31, 2010	1,077	5.6%	2,618	8.5%	4,601	81.7%	254	4.2%
December 31, 2009	819	6.0%	1,386	8.8%	4,688	80.5%	218	4.7%

Deposits

Total deposits were \$503.8 million and \$487.6 million at December 31, 2014 and 2013, respectively, which represents an increase of \$16.2 million or 3.33% during 2014. The table titled “Average Deposits and Rates Paid” shows the average deposit balances and average rates paid for 2014, 2013 and 2012.

Average Deposits and Rates Paid

(dollars in thousands)

	December 31,					
	2014		2013		2012	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing	\$ 149,026		\$ 136,242		\$ 115,667	
Interest-bearing:						
NOW accounts	82,821	0.11%	83,889	0.12%	80,500	0.17%
Money market accounts	94,650	0.11%	87,809	0.14%	84,241	0.25%
Regular savings accounts	67,515	0.05%	59,114	0.05%	52,635	0.07%
Time deposits:						
\$100,000 and more	35,341	0.51%	38,232	0.63%	48,065	0.79%
Less than \$100,000	61,136	0.84%	65,900	0.98%	71,810	1.14%
Total interest-bearing	\$ 341,463	0.27%	\$ 334,944	0.34%	\$ 337,251	0.47%
Total deposits	\$ 490,489		\$ 471,186		\$ 452,918	

Noninterest-bearing demand deposits, which are comprised of checking accounts, increased \$11.7 million or 7.89% from \$147.7 million at December 31, 2013 to \$159.4 million at December 31, 2014. Interest-bearing deposits, which include NOW accounts, money market accounts, regular savings accounts and time deposits, increased \$4.6 million or 1.35% from \$339.9 million at December 31, 2013 to \$344.5 million at December 31, 2014. Total NOW account balances decreased \$4.1 million or 4.70% from \$85.5 million at December 31, 2013 to \$81.4 million at December 31, 2014. Total money market account balances increased \$6.2 million or 6.72% from \$92.1 million at December 31, 2013 to \$98.3 million at December 31, 2014. Total regular savings account balances increased \$6.4 million or 10.11% from \$63.2 million at December 31, 2013 to \$69.6 million at December 31, 2014. Time deposits decreased \$3.9 million or 4.02% from \$99.1 million at December 31, 2013 to \$95.2 million at December 31, 2014. Pricing decisions made by management and influenced by the low interest rate environment resulted in the decline in certificate of deposits. Brokered certificates of deposits increased \$897 thousand or 7.45% from \$12.0 million at December 31, 2013 to \$12.9 million at December 31, 2014. This included \$11.0 million of traditional brokered certificates of deposit and \$1.9 million of certificates obtained through the CDARS network. These certificates were obtained through the CDARS network. The Bank joined the CDARS network in 2008, which allows it to offer over \$50 million in FDIC insurance on a certificate of deposit.

The Company attempts to fund asset growth with deposit accounts and focus upon core deposit growth as its primary source of funding. Core deposits consist of checking accounts, NOW accounts, money market accounts, regular savings accounts, and time deposits of less than \$100,000, excluding brokered certificates of deposit. Core deposits totaled \$490.9 million or 97.43% and \$475.5 million or 97.53% of total deposits at December 31, 2014 and 2013, respectively.

The table titled “Maturities of Certificates of Deposit and Other Time Deposits of \$100,000 and Greater” shows the amount of certificates of deposit of \$100,000 and more maturing within the time period indicated at December 31, 2014. The Company’s policy is to issue these certificates for terms of twelve months or less, however, exceptions have been made as indicated by the \$5.8 million which matures over one year. The total amount maturing within one year is \$29.6 million or 83.61% of the total amount outstanding.

Maturities of Certificates of Deposit and Other Time Deposits of \$100,000 and Greater

(dollars in thousands)

	Within Three Months	Three to Six Months	Six to Twelve Months	Over One Year	Total	Percent of Total Deposits
December 31, 2014	\$ 9,573	\$ 3,913	\$ 16,161	\$ 5,810	\$ 35,457	7.04%

CAPITAL RESOURCES

The Company continues to be a well capitalized financial institution. Total shareholders' equity on December 31, 2014 was \$73.1 million, reflecting a percentage of total assets of 11.67% as compared to \$66.4 million and 11.32% at December 31, 2013. The common stock's book value per share increased \$1.44 or 7.36% to \$21.01 per share at December 31, 2014 from \$19.57 per share at December 31, 2013. During 2014, the Company paid \$0.77 per share in dividends as compared to \$0.76 per share for 2013 and \$0.73 per share for 2012. The Company has a Dividend Investment Plan that allows participating shareholders to reinvest the dividends in Company stock.

Analysis of Capital

(dollars in thousands)

	December 31, 2014	December 31, 2013
Tier 1 Capital:		
Common stock	\$ 8,621	\$ 8,482
Capital surplus	12,618	11,537
Retained earnings	50,578	46,082
Trust preferred capital notes	7,000	7,000
Total Tier 1 capital	\$ 78,817	\$ 73,101
Tier 2 Capital:		
Allowance for loan losses	\$ 5,106	\$ 5,325
Total Tier 2 capital	\$ 5,106	\$ 5,325
Total risk-based capital	\$ 83,923	\$ 78,426
Risk weighted assets	\$ 440,277	\$ 425,778
Risk Based Capital Ratios:		
Tier 1 risk-based capital ratio	17.90%	17.17%
Total risk-based capital ratio	19.06%	18.42%
Tier 1 leverage ratio	12.86%	12.48%

Federal regulatory risk-based capital guidelines require percentages to be applied to various assets, including off-balance sheet assets, based on their perceived risk in order to calculate risk-weighted assets. Tier 1 capital consists of total shareholders' equity plus qualifying trust preferred securities outstanding less net unrealized gains and losses on available for sale securities, goodwill and other intangible assets. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses and any excess trust preferred securities that do not qualify as Tier 1 capital. The \$7,000,000 in trust preferred securities, issued by the Company during 2007, qualifies as Tier 1 capital because this amount does not exceed 25% of total capital, including the trust preferred securities. Financial institutions must maintain a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a minimum Tier 1 leverage ratio of 4%. The Company's policy requires a Tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10% and a minimum Tier 1 leverage ratio of 5%. The Company monitors these ratios on a quarterly basis and has several strategies, including without limitation the issuance of common stock or trust preferred securities, to ensure that these ratios remain above regulatory minimums. The table titled "Analysis of Capital" shows the components of Tier 1 capital, Tier 2 capital, the amount of total risk-based capital and risk-weighted assets, and the risk based capital ratios for the Company at December 31, 2014 and 2013.

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

LIQUIDITY

Liquidity management involves meeting the present and future financial obligations of the Company with the sale or maturity of assets or with the occurrence of additional liabilities. Liquidity needs are met with cash on hand, deposits in banks, federal funds sold, securities classified as available for sale and loans maturing within one year. At December 31, 2014 liquid assets totaled \$219.2 million as compared to \$202.4 million at December 31, 2013. These amounts represent 39.59% and 38.92% of total liabilities at December 31, 2014 and 2013, respectively. Securities provide a constant source of liquidity through paydowns and maturities. Also, the Company maintains short-term borrowing arrangements, namely federal funds lines of credit, with larger financial institutions as an additional source of liquidity. The Bank's membership with the Federal Home Loan Bank of Atlanta also provides a source of borrowings with numerous rate and term structures. The Company's senior management monitors the liquidity position regularly and attempts to maintain a position which utilizes available funds most efficiently. As a result of the Company's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Company maintains overall liquidity sufficient to satisfy its depositors' requirements and meet its customers' credit needs.

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

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

The table titled "Contractual Obligations and Scheduled Payments" presents the Company's contractual obligations and scheduled payment amounts due within the period indicated at December 31, 2014.

Contractual Obligations and Scheduled Payments

(dollars in thousands)

	December 31, 2014				
	Less than One Year	One Year through Three Years	Three Years through Five Years	More than Five Years	Total
FHLB advances	\$ 20,000	\$ 20,000	\$ —	\$ —	\$ 40,000
Trust preferred capital notes	—	—	—	7,217	7,217
Securities sold under agreements to repurchase	—	—	—	—	—
Operating leases	185	504	504	3,052	4,245
	<u>\$ 20,185</u>	<u>\$ 20,504</u>	<u>\$ 504</u>	<u>\$ 10,269</u>	<u>\$ 51,462</u>

The \$40.0 million in outstanding FHLB advances is comprised of three (3) advances. Note 8 to the Consolidated Financial Statements discusses the rates, terms, and conversion features on these advances. The trust preferred capital notes are discussed in Note 20 to the Consolidated Financial Statements. The payments due on operating leases are discussed in Note 6 to the Consolidated Financial Statements.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

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

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

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

Year 1 Net Interest Income Simulation

(dollars in thousands)

Assumed Market Interest Rate Shock	Change in Net Interest Income	
	Dollars	Percent Change
-100 BP	\$ (667)	(3.02)%
+100 BP	(275)	(1.24)%
+200 BP	(520)	(2.35)%
+300 BP	(736)	(3.33)%
+400 BP	(1,043)	(4.72)%

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

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

Static EVE Change

(dollars in thousands)

Assumed Market Interest Rate Shift	Change in EVE	
	Dollars	Percent Change
-100 BP Shock	\$ (16,042)	(14.95)%
+100 BP Shock	4,776	4.45 %
+200 BP Shock	7,386	6.88 %
+300 BP Shock	8,734	8.14 %
+400 BP Shock	9,431	8.79 %

Item 8. Financial Statements and Supplementary Data



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Eagle Financial Services, Inc. and its subsidiaries as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2014. The management of Eagle Financial Services, Inc. and its subsidiaries (the Company) is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Eagle Financial Services, Inc. and its subsidiaries as of December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America.

/s/ SMITH ELLIOTT KEARNS & COMPANY, LLC
SMITH ELLIOTT KEARNS & COMPANY, LLC

Chambersburg, Pennsylvania
March 30, 2015

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
December 31, 2014 and 2013
(dollars in thousands, except share amounts)

	<u>2014</u>	<u>2013</u>
Assets		
Cash and due from banks	\$ 9,075	\$ 9,295
Interest-bearing deposits with other institutions	25,489	4,948
Total cash and cash equivalents	<u>34,564</u>	<u>14,243</u>
Securities available for sale, at fair value	94,165	102,598
Restricted investments	2,808	2,192
Loans	469,820	444,273
Allowance for loan losses	(5,080)	(5,488)
Net Loans	<u>464,740</u>	<u>438,785</u>
Bank premises and equipment, net	19,015	17,214
Other real estate owned, net of allowance	2,102	1,646
Other assets	9,436	9,766
Total assets	<u>\$ 626,830</u>	<u>\$ 586,444</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest bearing demand deposits	\$ 159,352	\$ 147,698
Savings and interest bearing demand deposits	249,305	240,749
Time deposits	95,159	99,140
Total deposits	<u>\$ 503,816</u>	<u>\$ 487,587</u>
Federal Home Loan Bank advances	40,000	22,250
Trust preferred capital notes	7,217	7,217
Other liabilities	2,665	2,984
Total liabilities	<u>\$ 553,698</u>	<u>\$ 520,038</u>
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 2014, 3,463,665 including 15,151 unvested restricted stock; issued and outstanding 2013, 3,409,830 including 17,050 unvested restricted stock	8,621	8,482
Surplus	12,618	11,537
Retained earnings	50,578	46,082
Accumulated other comprehensive income	1,315	305
Total shareholders' equity	<u>\$ 73,132</u>	<u>\$ 66,406</u>
Total liabilities and shareholders' equity	<u>\$ 626,830</u>	<u>\$ 586,444</u>

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES
Consolidated Statements of Income
Years Ended December 31, 2014, 2013, and 2012
(dollars in thousands, except per share amounts)

	2014	2013	2012
Interest and Dividend Income			
Interest and fees on loans	\$ 21,695	\$ 21,530	\$ 22,589
Interest and dividends on securities available for sale:			
Taxable interest income	1,825	2,055	2,187
Interest income exempt from federal income taxes	1,096	1,241	1,383
Dividends	222	187	384
Interest on deposits in banks	12	23	23
Total interest and dividend income	<u>\$ 24,850</u>	<u>\$ 25,036</u>	<u>\$ 26,566</u>
Interest Expense			
Interest on deposits	924	1,142	1,586
Interest on federal funds purchased and securities sold under agreements to repurchase	20	31	360
Interest on Federal Home Loan Bank advances	650	1,094	1,120
Interest on trust preferred capital notes	132	135	148
Interest on interest rate swap	186	183	170
Total interest expense	<u>\$ 1,912</u>	<u>\$ 2,585</u>	<u>\$ 3,384</u>
Net interest income	<u>\$ 22,938</u>	<u>\$ 22,451</u>	<u>\$ 23,182</u>
Provision For Loan Losses	350	—	1,660
Net interest income after provision for loan losses	<u>\$ 22,588</u>	<u>\$ 22,451</u>	<u>\$ 21,522</u>
Noninterest Income			
Income from fiduciary activities	\$ 1,162	\$ 1,186	\$ 963
Service charges on deposit accounts	1,323	1,453	1,509
Other service charges and fees	2,995	3,864	3,404
(Loss) gain on sale of bank premises and equipment	(14)	(1)	—
Gain on sale of securities	990	465	45
Other operating income	150	495	206
Total noninterest income	<u>\$ 6,606</u>	<u>\$ 7,462</u>	<u>\$ 6,127</u>
Noninterest Expenses			
Salaries and employee benefits	\$ 11,427	\$ 11,451	\$ 10,634
Occupancy expenses	1,280	1,291	1,147
Equipment expenses	720	666	665
Advertising and marketing expenses	571	548	470
Stationery and supplies	307	274	289
ATM network fees	712	616	528
Other real estate owned expense	27	40	362
Loss (gain) on the sale of other real estate owned	(82)	140	(13)
FDIC assessment	357	375	292
Computer software expense	872	664	463
Bank franchise tax	466	407	383
Professional fees	988	1,013	1,072
Other bank service charges	73	695	79
Other operating expenses	2,268	2,187	2,169
Total noninterest expenses	<u>\$ 19,986</u>	<u>\$ 20,367</u>	<u>\$ 18,540</u>
Income before income taxes	<u>\$ 9,208</u>	<u>\$ 9,546</u>	<u>\$ 9,109</u>
Income Tax Expense			
Net income	<u>\$ 7,140</u>	<u>\$ 7,158</u>	<u>\$ 6,550</u>
Earnings Per Share			
Net income per common share, basic	<u>\$ 2.08</u>	<u>\$ 2.11</u>	<u>\$ 1.97</u>
Net income per common share, diluted	<u>\$ 2.07</u>	<u>\$ 2.10</u>	<u>\$ 1.96</u>

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
Years Ended December 31, 2014, 2013, and 2012
(dollars in thousands)

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Net income	\$ 7,140	\$ 7,158	\$ 6,550
Other comprehensive income (loss):			
Changes in benefit obligations and plan assets for defined benefit and post retirement benefit plans, net of deferred income taxes (benefit) of (\$3), \$0, and (\$4) for the years ended December 31, 2014, 2013, and 2012, respectively	(5)	—	(7)
Unrealized gain (loss) on available for sale securities, net of deferred income taxes (benefit) of \$473, (\$1,687), and \$289 for the years ended December 31, 2014, 2013, and 2012, respectively	919	(3,275)	560
Change in fair value of interest rate swap, net of deferred income taxes (benefit) of \$49, \$69, and (\$19) for the years ended December 31, 2014, 2013 and 2012, respectively	96	132	(36)
Total other comprehensive income (loss)	<u>1,010</u>	<u>(3,143)</u>	<u>517</u>
Total comprehensive income	<u>\$ 8,150</u>	<u>\$ 4,015</u>	<u>\$ 7,067</u>

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2014, 2013, and 2012
(dollars in thousands, except per share amounts)

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2011	\$ 8,217	\$ 9,568	\$ 37,374	\$ 2,931	\$ 58,090
Net income			\$ 6,550		6,550
Other comprehensive income				\$ 517	517
Restricted stock awards, stock incentive plan (10,963)	28	(28)			—
Income tax expense on vesting of restricted stock		4			4
Stock based compensation expense		242			242
Issuance of common stock, dividend investment plan (31,887 shares)	80	546			626
Issuance of common stock, employee benefit plan (6,180 shares)	15	92			107
Dividends declared (\$0.73 per share)			(2,430)		(2,430)
Balance, December 31, 2012	8,340	\$ 10,424	\$ 41,494	\$ 3,448	\$ 63,706
Net income			7,158		7,158
Other comprehensive (loss)				(3,143)	(3,143)
Restricted stock awards, stock incentive plan (13,699 shares)	34	(34)			—
Income tax benefit on vesting of restricted stock		35			35
Income tax benefit on disqualifying disposition of stock options exercised		5			5
Stock options exercised (3,872 shares)	10	59			69
Stock-based compensation expense		305			305
Issuance of common stock, dividend investment plan (30,627 shares)	77	585			662
Issuance of common stock, employee benefit plan (8,560 shares)	21	158			179
Dividends declared (\$0.76 per share)			(2,570)		(2,570)
Balance, December 31, 2013	8,482	\$ 11,537	\$ 46,082	\$ 305	\$ 66,406
Net income			7,140		7,140
Other comprehensive income				1,010	1,010
Restricted stock awards, stock incentive plan (14,009 shares)	35	(35)			—
Income tax benefit on vesting of restricted stock		21			21
Income tax benefit on disqualifying disposition of stock options exercised		7			7
Stock options exercised (927 shares)	2	(2)			—
Stock-based compensation expense		290			290
Issuance of common stock, dividend investment plan (31,904 shares)	80	620			700
Issuance of common stock, employee benefit plan (8,893 shares)	22	180			202
Dividends declared (\$0.77 per share)			(2,644)		(2,644)
Balance, December 31, 2014	8,621	\$ 12,618	\$ 50,578	\$ 1,315	\$ 73,132

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
Years Ended December 31, 2014, 2013, and 2012
(dollars in thousands)

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Cash Flows from Operating Activities			
Net income	\$ 7,140	\$ 7,158	6,550
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	772	803	821
Amortization of intangible and other assets	152	150	136
Provision for loan losses	350	—	1,660
(Gain) loss on the sale of other real estate owned	(82)	140	(13)
Loss on the sale and disposal of assets	18	1	2
(Gain) on the sale of securities	(990)	(465)	(45)
Stock-based compensation expense	290	305	242
Premium amortization on securities, net	124	146	191
Deferred tax benefit	142	1,190	350
Changes in assets and liabilities:			
(Increase) decrease in other assets	(451)	(1,392)	602
(Decrease) increase in other liabilities	(179)	183	937
Net cash provided by operating activities	<u>\$ 7,286</u>	<u>\$ 8,219</u>	<u>\$ 11,433</u>
Cash Flows from Investing Activities			
Proceeds from maturities and principal payments of securities available for sale	\$ 10,837	\$ 18,389	\$ 20,997
Proceeds from the sale of securities available for sale	8,546	3,987	3,357
Purchases of securities available for sale	(8,693)	(26,863)	(12,271)
Proceeds from the sale of restricted securities	284	585	743
Purchases of restricted securities	(900)	—	—
Purchases of bank premises and equipment	(2,966)	(1,492)	(2,201)
Proceeds from the sale of other real estate owned	745	1,167	895
Proceeds from the sale of repossessed assets	29	26	71
Net (increase) in loans	(27,085)	(27,290)	(13,213)
Net cash (used in) investing activities	<u>\$ (19,203)</u>	<u>\$ (31,491)</u>	<u>\$ (1,622)</u>
Cash Flows from Financing Activities			
Net increase in demand deposits, money market and savings accounts	\$ 20,210	\$ 22,327	\$ 48,725
Net (decrease) in certificates of deposit	(3,980)	(11,841)	(20,089)
Net increase in federal funds purchased and securities sold under agreements to repurchase	—	10,000	—
Net increase (decrease) in Federal Home Loan Bank advances	17,750	(10,000)	(10,000)
Issuance of common stock, employee benefit plan	202	179	107
Stock options exercised	—	69	—
Cash dividends paid	(1,944)	(1,909)	(1,805)
Net cash provided by (used in) financing activities	<u>\$ 32,238</u>	<u>\$ (11,175)</u>	<u>\$ 16,938</u>

See Notes to Consolidated Financial Statements

EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows (continued)
Years Ended December 31, 2014, 2013, and 2012
(dollars in thousands)

	2014	2013	2012
Increase (decrease) in cash and cash equivalents	\$ 20,321	\$ (34,447)	\$ 26,749
Cash and Cash Equivalents			
Beginning	14,243	48,690	21,941
Ending	<u>\$ 34,564</u>	<u>\$ 14,243</u>	<u>\$ 48,690</u>
Supplemental Disclosures of Cash Flow Information			
Cash payments for:			
Interest	<u>\$ 1,916</u>	<u>\$ 2,704</u>	<u>\$ 3,436</u>
Income taxes	<u>\$ 1,985</u>	<u>\$ 2,097</u>	<u>\$ 2,210</u>
Supplemental Schedule of Noncash Investing and Financing Activities:			
Unrealized gain (loss) on securities available for sale	<u>\$ 1,392</u>	<u>\$ (4,962)</u>	<u>\$ 849</u>
Change in fair value of interest rate swap	<u>\$ 145</u>	<u>\$ 201</u>	<u>\$ (55)</u>
Other real estate acquired in settlement of loans	<u>\$ 781</u>	<u>\$ 25</u>	<u>\$ 1,715</u>
Issuance of common stock, dividend investment plan	<u>\$ 700</u>	<u>\$ 662</u>	<u>\$ 626</u>

See Notes to Consolidated Financial Statements

NOTE 1. Nature of Banking Activities and Significant Accounting Policies

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

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

Principles of Consolidation

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

Trust Assets

Securities and other property held by the Eagle Investment Group in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Cash and Cash Equivalents

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

Securities

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

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

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

Loans

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

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan fees collected and certain costs incurred related to loan originations are deferred and amortized as an adjustment to interest income over the life of the related loans. Deferred fees and costs are recorded as an adjustment to loans outstanding using a method that approximates a constant yield.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful.

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

Risks by Loan Portfolio Segments

One-to-Four-Family Residential Real Estate Lending

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

Commercial Real Estate Lending

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

Construction and Land Development Lending

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

Commercial and Industrial Lending

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

Consumer Lending

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

Allowance for Loan Losses

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are impaired. An allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience and other qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

Bank Premises and Equipment

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

Other Real Estate Owned

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the fair value of the property, less estimated selling costs at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less estimated cost to sell. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. During 2014, there were no other real estate owned properties that were in the process of being developed by the Bank. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in the net expenses from foreclosed assets.

Retirement Plans

The Company had a non-contributory defined benefit pension plan that covers eligible employees. Effective December 31, 2006, the pension plan was amended so that no further benefits would accrue under the plan and no additional employees could become participants. The plan was terminated during 2012 after receiving final IRS approval. Refer to Note 10 for a description of the termination of the Company's pension plan. The Company also sponsors a 401(k) savings plan under which eligible employees may defer a portion of their compensation on a pretax basis. The Company also provides a match to participants in this plan, as described more fully in Note 12.

Stock-Based Compensation Plan

During 2003, the Company's shareholders approved a stock incentive plan which allows key employees and directors to increase their personal financial interest in the Company. This plan permits the issuance of incentive stock options and non-qualified stock options and the award of stock appreciation rights, common stock, restricted stock, and phantom stock. The plan, as adopted, authorized the issuance of up to 300,000 shares of common stock. This plan is discussed more fully in Note 11.

Income Taxes

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

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

Advertising

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

Reclassifications

Certain reclassifications have been made to the 2013 financial statements to conform to reporting for 2014. The results of the reclassification are not considered material and have no effect on reported amounts for prior years.

Earnings Per Common Share

Basic earnings per share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. The number of potential common shares is determined using the treasury method and relates to outstanding stock options and nonvested restricted stock grants.

The following table shows the weighted average number of shares used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock. Potential dilutive common stock had no effect on income available to common shareholders.

	2014	2013	2012
Average number of common shares outstanding	3,438,348	3,386,467	3,333,235
Effect of dilutive common stock	8,470	11,275	10,037
Average number of common shares outstanding used to calculate diluted earnings per share	3,446,818	3,397,742	3,343,272

Comprehensive Income

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

The components of the change in unrealized gains (losses) on securities during 2014, 2013, and 2012 were as follows:

	2014	2013	2012
Gross unrealized gain (loss)	\$ 2,382	\$ (4,497)	\$ 894
Reclassification adjustment for realized (gain)	(990)	(465)	(45)
Net unrealized gain (loss) before taxes	1,392	(4,962)	849
Tax effect	(473)	1,687	(289)
	<u>\$ 919</u>	<u>\$ (3,275)</u>	<u>\$ 560</u>

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

	Unrealized Gain (Loss) on Securities	Change in Fair Value of Interest Rate Swap	Post Retirement Benefit Plan	Total
December 31, 2012	\$ 3,822	\$ (418)	\$ 44	\$ 3,448
2013 Change	(3,275)	132	—	(3,143)
December 31, 2013	547	(286)	44	305
2014 Change	919	96	(5)	1,010
December 31, 2014	<u>\$ 1,466</u>	<u>\$ (190)</u>	<u>\$ 39</u>	<u>\$ 1,315</u>

Derivative Financial Instruments

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

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

Use of Estimates

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

Stock Repurchase Program

On June 11, 2014, the Corporation renewed the stock repurchase program to repurchase up to 150,000 shares of its common stock prior to June 30, 2015. There was no repurchase activity during 2014, 2013 and 2012. The maximum number of shares that may yet be purchased under the plan as of December 31, 2014 are 134,337.

Recent Accounting Pronouncements

In January 2014, the FASB issued ASU 2014-01, "Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company is currently assessing the impact that ASU 2014-01 will have on its consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, "Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements.

In April 2014, the FASB issued ASU 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." The amendments in this ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results and include disposals of a major geographic area, a major line of business, or a major equity method investment. The new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. Additionally, the new guidance requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in the ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-08 to have a material impact on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606". This ASU applies to any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the revenue recognition requirements in Topic 605, "Revenue Recognition", most industry-specific guidance, and some cost guidance included in Subtopic 605-35, "Revenue Recognition-Construction-Type and Production-Type Contracts". The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2014-09 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU 2014-10, "Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation". The amendments in this ASU remove all incremental financial reporting requirements from U.S. GAAP for development stage entities, including the removal of Topic 915, "Development Stage Entities", from the FASB Accounting Standards Codification. In addition, this ASU adds an example disclosure and removes an exception provided to development stage entities in Topic 810, "Consolidation", for determining whether an entity is a variable interest entity. The presentation and disclosure requirements in Topic 915 will no longer be required for the first annual period beginning after December 15, 2014. The revised consolidation standards are effective for annual periods beginning after December 15, 2015. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-10 to have a material impact on its consolidated financial statements.

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

In June 2014, the FASB issued ASU No. 2014-12, "Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period". The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in "Compensation - Stock Compensation (Topic 718)", should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company is currently assessing the impact that ASU 2014-12 will have on its consolidated financial statements.

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

In November 2014, the FASB issued ASU No. 2014-16, “Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity.” The amendments in ASU do not change the current criteria in U.S. GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. The amendments clarify how current U.S. GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features, including the embedded derivative feature being evaluated for bifurcation, in evaluating the nature of the host contract. Furthermore, the amendments clarify that no single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument. The amendments in this ASU also clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (i.e., the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption, including adoption in an interim period, is permitted. The Company does not expect the adoption of ASU 2014-16 to have a material impact on its consolidated financial statements.

In November 2014, the FASB issued ASU No. 2014-17, “Business Combinations (Topic 805): Pushdown Accounting.” The amendments in ASU provide an acquired entity with an option to apply pushdown accounting in its separate financial statements upon occurrence of an event in which an acquirer obtains control of the acquired entity. An acquired entity may elect the option to apply pushdown accounting in the reporting period in which the change-in-control event occurs. An acquired entity should determine whether to elect to apply pushdown accounting for each individual change-in-control event in which an acquirer obtains control of the acquired entity. If pushdown accounting is not applied in the reporting period in which the change-in-control event occurs, an acquired entity will have the option to elect to apply pushdown accounting in a subsequent reporting period to the acquired entity’s most recent change-in-control event. An election to apply pushdown accounting in a reporting period after the reporting period in which the change-in-control event occurred should be considered a change in accounting principle in accordance with Topic 250, Accounting Changes and Error Corrections. If pushdown accounting is applied to an individual change-in-control event, that election is irrevocable. The amendments in this ASU are effective on November 18, 2014. After the effective date, an acquired entity can make an election to apply the guidance to future change-in-control events or to its most recent change-in-control event. However, if the financial statements for the period in which the most recent change-in-control event occurred already have been issued or made available to be issued, the application of this guidance would be a change in accounting principle. The Company does not expect the adoption of ASU 2014-17 to have a material impact on its consolidated financial statements.

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

NOTE 2. Securities

Amortized costs and fair values of securities available for sale at December 31, 2014 and 2013 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
December 31, 2014				
(in thousands)				
Obligations of U.S. government corporations and agencies	\$ 36,911	\$ 599	\$ (299)	\$ 37,211
Mortgage-backed securities	15,245	545	(11)	15,779
Obligations of states and political subdivisions	39,025	1,432	(47)	40,410
Corporate securities	761	4	—	765
Equity securities	—	—	—	—
	<u>\$ 91,942</u>	<u>\$ 2,580</u>	<u>\$ (357)</u>	<u>\$ 94,165</u>
December 31, 2013				
(in thousands)				
Obligations of U.S. government corporations and agencies	\$ 35,890	\$ 439	\$ (1,585)	\$ 34,744
Mortgage-backed securities	14,896	422	(121)	15,197
Obligations of states and political subdivisions	42,442	969	(295)	43,116
Corporate securities	7,495	928	—	8,423
Equity securities	1,044	74	—	1,118
	<u>\$ 101,767</u>	<u>\$ 2,832</u>	<u>\$ (2,001)</u>	<u>\$ 102,598</u>

Carrying amounts of restricted securities at December 31, 2014 and 2013 were as follows:

	December 31, 2014	December 31, 2013
(in thousands)		
Federal Reserve Bank Stock	\$ 344	\$ 344
Federal Home Loan Bank Stock	2,324	1,708
Community Bankers' Bank Stock	140	140
	<u>\$ 2,808</u>	<u>\$ 2,192</u>

The amortized cost and fair value of securities available for sale at December 31, 2014, by contractual maturity, are shown below. Maturities may differ from contractual maturities in mortgage-backed securities because the mortgages underlying the securities may be called or repaid without any penalties.

	Amortized Cost	Fair Value
(in thousands)		
Due in one year or less	\$ 3,680	\$ 3,712
Due after one year through five years	27,507	28,046
Due after five years through ten years	42,414	43,394
Due after ten years	18,341	19,013
Equity securities	—	—
	<u>\$ 91,942</u>	<u>\$ 94,165</u>

During the twelve months ended December 31, 2014, the Company sold \$8.5 million in available for sale securities for a net gain of \$990 thousand. During the twelve months ended December 31, 2013, the Company sold \$4.0 million in available for sale securities for a net gain of \$465 thousand. During the twelve months ended December 31, 2012, the Company sold \$3.4 million in available for sale securities for a net gain of \$45 thousand.

The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at December 31, 2014 and 2013 were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2014						
(in thousands)						
Obligations of U.S. government corporations and agencies	\$ 1,997	\$ 1	\$ 21,615	\$ 298	\$ 23,612	\$ 299
Mortgage-backed securities	—	—	1,444	11	1,444	11
Obligations of states and political subdivisions	2,998	12	2,414	35	5,412	47
Corporate securities	—	—	—	—	—	—
Equity securities	—	—	—	—	—	—
	<u>\$ 4,995</u>	<u>\$ 13</u>	<u>\$ 25,473</u>	<u>\$ 344</u>	<u>\$ 30,468</u>	<u>\$ 357</u>
December 31, 2013						
(in thousands)						
Obligations of U.S. government corporations and agencies	\$ 23,235	\$ 1,551	\$ 1,967	\$ 34	\$ 25,202	\$ 1,585
Mortgage-backed securities	2,828	121	—	—	2,828	121
Obligations of states and political subdivisions	8,439	252	466	43	8,905	295
Corporate securities	—	—	—	—	—	—
Equity securities	—	—	—	—	—	—
	<u>\$ 34,502</u>	<u>\$ 1,924</u>	<u>\$ 2,433</u>	<u>\$ 77</u>	<u>\$ 36,935</u>	<u>\$ 2,001</u>

Gross unrealized losses on available for sale securities included thirty-eight (38) and fifty-one (51) debt securities at December 31, 2014 and December 31, 2013, respectively. The Company evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The Company's mortgage-backed securities are issued by U.S. government agencies, which guarantee payments to investors regardless of the status of the underlying mortgages. Consideration is given to the length of time and the amount of an unrealized loss, the financial condition of the issuer, and the intent and ability of the Company to retain its investment in the issuer long enough to allow for an anticipated recovery in fair value. The fair value of a security reflects its liquidity as compared to similar instruments, current market rates on similar instruments, and the creditworthiness of the issuer. Absent any change in the liquidity of a security or the creditworthiness of the issuer, prices will decline as market rates rise and vice-versa. The primary cause of the unrealized losses at December 31, 2014 and December 31, 2013 was changes in market interest rates. Since the losses can be primarily attributed to changes in market interest rates and not expected cash flows or an issuer's financial condition, the unrealized losses are deemed to be temporary. The continuing economic recession involving housing, liquidity and credit were also contributing factors to the unrealized losses on these securities at December 31, 2014 and December 31, 2013. The Company monitors the financial condition of these issuers continuously and will record other-than-temporary impairment if the recovery of value is unlikely.

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

Securities having a carrying value of \$3.4 million at December 31, 2014 were pledged to secure securities sold under agreements to repurchase and for other purposes required by law.

NOTE 3. Loans

The composition of loans at December 31, 2014 and 2013 was as follows:

	December 31,	
	2014	2013
	(in thousands)	
Mortgage loans on real estate:		
Construction and land development	\$ 25,887	\$ 27,047
Secured by farmland	10,602	9,886
Secured by 1-4 family residential properties	224,694	218,633
Multifamily	3,016	2,850
Commercial	161,299	148,166
Loans to farmers	957	1,321
Commercial and industrial loans	28,132	20,865
Consumer installment loans	13,874	13,785
All other loans	1,359	1,720
	<u>\$ 469,820</u>	<u>\$ 444,273</u>
Less: Allowance for loan losses	5,080	5,488
	<u>\$ 464,740</u>	<u>\$ 438,785</u>

NOTE 4. Allowance for Loan Losses

Changes in the allowance for loan losses for the years December 31, 2014, 2013 and 2012 were as follows:

	December 31,		
	2014	2013	2012
	(in thousands)		
Balance, beginning	\$ 5,488	\$ 6,577	\$ 8,743
Provision charged to operating expense	350	—	1,660
Recoveries added to the allowance	725	233	337
Loan losses charged to the allowance	(1,483)	(1,322)	(4,163)
Balance, ending	<u>\$ 5,080</u>	<u>\$ 5,488</u>	<u>\$ 6,577</u>

Nonaccrual and past due loans by class at December 31, 2014 and December 31, 2013 were as follows:

December 31, 2014								
(in thousands)								
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Current	Total Loans	90 or More Days Past Due Still Accruing	Nonaccrual Loans
Commercial - Non Real Estate:								
Commercial & Industrial	\$ 28	\$ —	\$ —	\$ 28	\$ 28,104	\$ 28,132	\$ —	\$ 2,106
Commercial Real Estate:								
Owner Occupied	2,191	—	—	2,191	97,516	99,707	—	2,591
Non-owner occupied	56	210	808	1,074	60,518	61,592	—	1,231
Construction and Farmland:								
Residential	—	52	—	52	5,149	5,201	—	—
Commercial	—	—	57	57	31,231	31,288	—	787
Consumer:								
Installment	50	15	6	71	13,803	13,874	6	—
Residential:								
Equity Lines	132	41	185	358	30,763	31,121	—	331
Single family	1,243	440	644	2,327	191,246	193,573	—	3,660
Multifamily	—	—	—	—	3,016	3,016	—	—
All Other Loans	—	—	—	—	2,316	2,316	—	—
Total	\$ 3,700	\$ 758	\$ 1,700	\$ 6,158	\$ 463,662	\$ 469,820	\$ 6	\$ 10,706

December 31, 2013								
(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	\$ 143	\$ —	\$ 1,162	\$ 1,305	\$ 19,560	\$ 20,865	\$ —	\$ 1,288
Commercial Real Estate:								
Owner Occupied	364	—	1,270	1,634	90,811	92,445	—	1,269
Non-owner occupied	99	185	—	284	55,437	55,721	—	185
Construction and Farmland:								
Residential	—	—	—	—	7,860	7,860	—	—
Commercial	—	—	—	—	29,073	29,073	—	157
Consumer:								
Installment	95	9	11	115	13,670	13,785	11	6
Residential:								
Equity Lines	202	25	—	227	31,997	32,224	—	179
Single family	1,995	180	693	2,868	183,541	186,409	—	1,328
Multifamily	—	—	—	—	2,850	2,850	—	—
All Other Loans	—	—	—	—	3,041	3,041	—	—
Total	\$ 2,898	\$ 399	\$ 3,136	\$ 6,433	\$ 437,840	\$ 444,273	\$ 11	\$ 4,412

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

As of and for the Twelve Months Ended								
December 31, 2014								
(in thousands)								
	Construction and Farmland	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$ 1,032	\$ 2,225	\$ 1,337	\$ 555	\$ 102	\$ 82	\$ 155	\$ 5,488
Charge-Offs	(482)	(808)	(83)	—	(86)	(24)	—	(1,483)
Recoveries	26	63	381	164	87	4	—	725
Provision	375	497	(288)	(255)	—	(20)	41	350
Ending balance	\$ 951	\$ 1,977	\$ 1,347	\$ 464	\$ 103	\$ 42	\$ 196	\$ 5,080
Ending balance: Individually evaluated for impairment	\$ 93	\$ 303	\$ 203	\$ 44	\$ —	\$ —	\$ —	\$ 643
Ending balance: collectively evaluated for impairment	\$ 858	\$ 1,674	\$ 1,144	\$ 420	\$ 103	\$ 42	\$ 196	\$ 4,437
Financing receivables:								
Ending balance	\$ 36,489	\$ 227,710	\$ 161,299	\$ 28,132	\$ 13,874	\$ 2,316	\$ —	\$ 469,820
Ending balance individually evaluated for impairment	\$ 2,669	\$ 6,557	\$ 5,722	\$ 2,107	\$ —	\$ —	\$ —	\$ 17,055
Ending balance collectively evaluated for impairment	\$ 33,820	\$ 221,153	\$ 155,577	\$ 26,025	\$ 13,874	\$ 2,316	\$ —	\$ 452,765

As of and for the Twelve Months Ended								
December 31, 2013								
(in thousands)								
	Construction and Farmland	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	All Other Loans	Unallocated	Total
Allowance for credit losses:								
Beginning Balance	\$ 1,280	\$ 2,820	\$ 1,182	\$ 880	\$ 107	\$ 122	\$ 186	\$ 6,577
Charge-Offs	(20)	(507)	(289)	(403)	(85)	(18)	—	(1,322)
Recoveries	5	109	7	47	54	11	—	233
Provision	(233)	(197)	437	31	26	(33)	(31)	—
Ending balance	\$ 1,032	\$ 2,225	\$ 1,337	\$ 555	\$ 102	\$ 82	\$ 155	\$ 5,488
Ending balance: Individually evaluated for impairment	\$ 218	\$ 627	\$ 299	\$ 334	\$ —	\$ —	\$ —	\$ 1,478
Ending balance: collectively evaluated for impairment	\$ 814	\$ 1,598	\$ 1,038	\$ 221	\$ 102	\$ 82	\$ 155	\$ 4,010
Financing receivables:								
Ending balance	\$ 36,933	\$ 221,483	\$ 148,166	\$ 20,865	\$ 13,785	\$ 3,041	\$ —	\$ 444,273
Ending balance individually evaluated for impairment	\$ 2,674	\$ 4,922	\$ 4,750	\$ 1,347	\$ —	\$ 6	\$ —	\$ 13,699
Ending balance collectively evaluated for impairment	\$ 34,259	\$ 216,561	\$ 143,416	\$ 19,518	\$ 13,785	\$ 3,035	\$ —	\$ 430,574

Impaired loans by class at December 31, 2014 and December 31, 2013 were as follows:

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

As of and for the Year Ended

December 31, 2013

(in thousands)

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 289	\$ 145	\$ —	\$ 329	\$ 8
Commercial Real Estate:					
Owner Occupied	2,474	2,273	—	2,512	118
Non-owner occupied	1,470	1,398	—	1,498	91
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	2,391	2,401	—	2,420	97
Residential:					
Equity lines	455	290	—	460	16
Single family	3,390	3,100	—	3,531	146
Multifamily	—	—	—	—	—
Other Loans	6	6	—	7	1
	<u>\$ 10,475</u>	<u>\$ 9,613</u>	<u>\$ —</u>	<u>\$ 10,757</u>	<u>\$ 477</u>
With an allowance recorded:					
Commercial - Non Real Estate:					
Commercial & Industrial	\$ 1,243	\$ 1,221	\$ 334	\$ 1,271	\$ 59
Commercial Real Estate:					
Owner Occupied	—	—	—	—	—
Non-owner occupied	1,108	1,111	299	1,126	49
Construction and Farmland:					
Residential	—	—	—	—	—
Commercial	301	283	218	308	18
Residential:					
Equity lines	75	74	74	217	7
Single family	1,505	1,508	553	1,530	71
Multifamily	—	—	—	—	—
Other Loans	—	—	—	—	—
	<u>\$ 4,232</u>	<u>\$ 4,197</u>	<u>\$ 1,478</u>	<u>\$ 4,452</u>	<u>\$ 204</u>
Total:					
Commercial	\$ 1,532	\$ 1,366	\$ 334	\$ 1,600	\$ 67
Commercial Real Estate	5,052	4,782	299	5,136	258
Construction and Farmland	2,692	2,684	218	2,728	115
Residential	5,425	4,972	627	5,738	240
Other	6	6	—	7	1
Total	<u>\$ 14,707</u>	<u>\$ 13,810</u>	<u>\$ 1,478</u>	<u>\$ 15,209</u>	<u>\$ 681</u>

Recorded investment is defined as the summation of the principal balance, accrued interest, and net deferred loan fees or costs. For the year ended December 31, 2012, the average recorded investment of impaired loans was \$17.7 million. The interest income recognized on impaired loans was \$743 thousand in 2012.

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

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

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

Credit quality information by class at December 31, 2014 and December 31, 2013 was as follows:

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

Consumer Credit Exposure by Payment Activity	Performing	Nonperforming
	\$ 13,803	\$ 71

INTERNAL RISK RATING GRADES	As of December 31, 2013 (in thousands)						
	Pass	Pass Monitored	Special Mention	Substandard	Doubtful	Loss	Total
	Commercial - Non Real Estate:						
Commercial & Industrial	\$ 16,565	\$ 2,820	\$ 86	\$ 106	\$ 1,288	\$ —	\$ 20,865
Commercial Real Estate:							
Owner Occupied	73,998	12,036	3,322	1,820	1,269	—	92,445
Non-owner occupied	31,484	14,922	5,557	3,758	—	—	55,721
Construction and Farm land:							
Residential	7,738	122	—	—	—	—	7,860
Commercial	24,252	1,353	1,196	2,186	86	—	29,073
Residential:							
Equity Lines	30,458	708	415	480	163	—	32,224
Single family	157,273	11,505	11,046	5,775	810	—	186,409
Multifamily	1,946	904	—	—	—	—	2,850
All other loans	3,041	—	—	—	—	—	3,041
Total	\$ 346,755	\$ 44,370	\$ 21,622	\$ 14,125	\$ 3,616	\$ —	\$ 430,488

Consumer Credit Exposure by Payment Activity	Performing	Nonperforming
	\$ 13,670	\$ 115

No consumer loans were rated below Pass at December 31, 2014. One consumer loan was rated as special mention for \$3 thousand and one consumer loan was rated as doubtful for \$6 thousand at December 31, 2013.

NOTE 5. Troubled Debt Restructurings

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

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

There were twenty-five (25) troubled debt restructured loans totaling \$7.8 million at December 31, 2014. At December 31, 2013, there were twenty (20) troubled debt restructured loans totaling \$6.4 million. Eight loans, totaling \$1.4 million, were in nonaccrual status at December 31, 2014. Five loans, totaling \$1.7 million, were in nonaccrual status at December 31, 2013. There were no outstanding commitments to lend additional amounts to troubled debt restructured borrowers at December 31, 2014.

The following tables set forth information on the Company’s troubled debt restructurings by class of financing receivable occurring during the years ended December 31, 2014 and 2013:

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

	For the Year Ended December 31, 2013 (in thousands)		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Construction and Farmland:			
Commercial	2	\$ 1,608	\$ 1,608
Residential:			
Equity	1	184	184
Single family	2	338	338
Total	<u>5</u>	<u>\$ 2,130</u>	<u>\$ 2,130</u>

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

During the twelve months ended December 31, 2013, the Company restructured five loans by granting concessions to borrowers experiencing financial difficulties. One commercial construction and farmland loan was modified by extending the term of the loan and keeping the loan on interest only payments. One commercial construction and farmland loan was modified by granting a lower interest rate. One single family residential loan was modified by changing the amortization period and granting a lower interest rate. One single family residential loan was modified by forgiving a portion of the loan balance and extending the term of the loan. One residential equity loan was modified by changing payments to interest-only in order to reduce the monthly payment for a period of time.

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

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

	For the Year Ended December 31, 2013 (in thousands)	
	Number of Contracts	Recorded Investment
Construction and Farmland:		
Commercial	2	1,614
Total	2	\$ 1,614

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

NOTE 6. Bank Premises and Equipment, Net

The major classes of bank premises and equipment and the total accumulated depreciation at December 31, 2014 and 2013 were as follows:

	December 31,	
	2014	2013
	(in thousands)	
Land	\$ 6,406	\$ 4,865
Buildings and improvements	17,290	16,795
Furniture and equipment	7,972	7,654
	<u>\$ 31,668</u>	<u>\$ 29,314</u>
Less accumulated depreciation	12,653	12,100
Bank premises and equipment, net	<u>\$ 19,015</u>	<u>\$ 17,214</u>

Depreciation expense on buildings and improvements was \$446 thousand, \$434 thousand, and \$432 thousand for the years ended 2014, 2013, and 2012, respectively. Depreciation expense on furniture and equipment was \$326 thousand, \$368 thousand, and \$389 thousand for the years ended 2014, 2013, and 2012, respectively.

The Bank leases certain facilities under operating leases, which expire at various dates through 2032. These leases require payment of certain operating expenses and contain renewal options. The total minimum rental commitment at December 31, 2014 under these leases was due as follows:

	December 31, 2014
	(in thousands)
2015	\$ 185
2016	252
2017	252
2018	252
2019	252
Thereafter	3,052
	<u>\$ 4,245</u>

The total building and equipment rental expense was \$135 thousand, \$138 thousand, and \$144 thousand in 2014, 2013, and 2012, respectively.

NOTE 7. Deposits

The composition of deposits at December 31, 2014 and December 31, 2013 was as follows:

	December 31,	
	2014	2013
	(in thousands)	
Noninterest bearing demand deposits	\$ 159,352	\$ 147,698
Savings and interest bearing demand deposits:		
NOW accounts	\$ 81,441	\$ 85,459
Money market accounts	98,314	92,125
Regular savings accounts	69,550	63,165
	<u>\$ 249,305</u>	<u>\$ 240,749</u>
Time deposits:		
Balances of less than \$250,000	\$ 85,899	\$ 91,076
Balances of \$250,000 and more	9,260	8,064
	<u>\$ 95,159</u>	<u>\$ 99,140</u>
	<u>\$ 503,816</u>	<u>\$ 487,587</u>

Time deposits with balances of less than \$250,000 include \$12.9 million and \$12.0 million in brokered certificates of deposit at December 31, 2014 and 2013, respectively. There were no time deposits with balances of \$250,000 and more in brokered certificates of deposit at December 31, 2014 and 2013, respectively.

The outstanding balance of time deposits at December 31, 2014 was due as follows:

	December 31, 2014
	(in thousands)
2015	\$ 66,667
2016	8,999
2017	15,029
2018	1,600
2019	2,647
Thereafter	217
	<u>\$ 95,159</u>

Deposit overdrafts reclassified as loans totaled \$121 thousand and \$169 thousand at December 31, 2014 and 2013, respectively.

NOTE 8. Borrowings

The Company, through its subsidiary bank, borrows funds in the form of federal funds purchased, securities sold under agreements to repurchase and Federal Home Loan Bank advances.

Federal fund lines of credit are extended to the Bank by nonaffiliated banks with which a correspondent banking relationship exists. The line of credit amount is determined by the creditworthiness of the Bank and, in particular, its regulatory capital ratios, which are discussed in Note 16. Federal funds purchased generally mature each business day. The following table summarizes information related to federal funds purchased for the years ended December 31, 2014 and 2013:

	December 31,	
	2014	2013
	(dollars in thousands)	
Balance at year-end	\$ —	\$ —
Average balance during the year	1,865	270
Average interest rate during the year	1.08%	0.88%
Maximum month-end balance during the year	\$ 10,245	\$ 5,616
Gross lines of credit at year-end	36,000	36,000
Unused lines of credit at year-end	36,000	36,000

As of December 31, 2014, the Company also had a \$5.0 million gross and unused line of credit, in addition to the \$36.0 million in federal funds lines of credit listed in the table above.

Securities sold under agreements to repurchase are borrowings in which the Bank obtains funds by selling securities and simultaneously agreeing to repurchase the securities for an agreed upon term at a given price which includes interest. The Company had no funds from customers through retail repurchase agreements at December 31, 2014. Generally, the term for retail repurchase agreements is the next business day. The Company had no funds from a larger financial institution through a wholesale repurchase agreement at December 31, 2014. The amount of borrowings through securities sold under agreements to repurchase is restricted by the amount of securities which are designated for these transactions.

The following table summarizes information related to securities sold under agreement to repurchase for the years ended December 31, 2014 and 2013:

	December 31,	
	2014	2013
	(dollars in thousands)	
Balance at year-end	\$ —	\$ —
Average balance during the year	—	795
Average interest rate during the year	—%	3.58%
Maximum month-end balance during the year	\$ —	\$ —
Securities underlying the agreements at year-end:		
Carrying value	—	—
Fair value	—	—

As of December 31, 2014, Company had remaining credit availability in the amount of \$65.4 million at the Federal Home Loan Bank of Atlanta. This line may be utilized for short and/or long-term borrowing. Advances on the line are secured by all of the Company's eligible first lien residential real estate loans on one-to-four-unit, single-family dwellings; multi-family dwellings; home equity lines of credit; and commercial real estate loans. The amount of the available credit is limited to a percentage of the estimated market value of the loans as determined periodically by the FHLB of Atlanta. The amount of the available credit is also limited to 20% of total Bank assets.

The Company had \$40.0 million in borrowings with the FHLB at December 31, 2014, which matures as follows: \$20.0 million in 2015 and \$20.0 million in 2017. The Company had \$20.0 million in long-term borrowings with the FHLB at December 31, 2014. The interest rate on the outstanding long-term advance at December 31, 2014 was 1.30%. The Company had \$20.0 million short-term borrowings with the FHLB at December 31, 2014. The interest rates on the outstanding short-term advances at December 31, 2014 ranged from 3.0175% to 3.025%. The weighted average interest rate on outstanding short-term advances at December 31, 2014 was 3.021%. The Company also had a \$15.0 million irrevocable letter of credit at December 31, 2014 with the FHLB to secure public deposits.

NOTE 9. Income Taxes

The Company files income tax returns with the United States of America and the Commonwealth of Virginia. With few exceptions, the Company is no longer subject to federal, state, or local income tax examinations for years prior to 2011.

The net deferred tax asset at December 31, 2014 and 2013 consisted of the following components:

	December 31,	
	2014	2013
	(in thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 1,727	\$ 1,866
Deferred compensation	120	125
Accrued postretirement benefits	47	51
Home equity origination costs	51	41
Other than temporary impairment	—	30
Interest rate swap	98	148
Other real estate owned valuation allowance	—	116
Other	391	381
	<u>\$ 2,434</u>	<u>\$ 2,758</u>
Deferred tax liabilities:		
Property and equipment	\$ 405	\$ 533
Securities available for sale	756	283
	<u>\$ 1,161</u>	<u>\$ 816</u>
Net deferred tax asset	<u>\$ 1,273</u>	<u>\$ 1,942</u>

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

Income tax expense for the years ended December 31, 2014, 2013 and 2012 consisted of the following components:

	December 31,		
	2014	2013	2012
	(in thousands)		
Current tax expense	\$ 1,926	\$ 1,198	\$ 2,209
Deferred tax expense (benefit)	142	1,190	350
	<u>\$ 2,068</u>	<u>\$ 2,388</u>	<u>\$ 2,559</u>

The following table reconciles income tax expense to the statutory federal corporate income tax amount, which was calculated by applying the federal corporate income tax rate to pre-tax income for the years ended December 31, 2014, 2013 and 2012.

	December 31,		
	2014	2013	2012
	(in thousands)		
Statutory federal corporate tax amount	\$ 3,131	\$ 3,246	\$ 3,097
Tax-exempt interest (income)	(454)	(495)	(563)
Officer insurance loss (income)	9	(82)	7
Net tax credits	(593)	(312)	—
Other	(25)	31	18
	<u>\$ 2,068</u>	<u>\$ 2,388</u>	<u>\$ 2,559</u>

The effective tax rates were 22.46%, 25.02%, and 28.09%, for years ended December 31, 2014, 2013, and 2012, respectively.

NOTE 10. Postretirement Benefit Plans

The Company provides certain health care and life insurance benefits for nine retired employees who have met certain eligibility requirements. All other employees retiring after reaching age 65 and having at least 15 years of service with the Company will be allowed to stay on the Company's group life and health insurance policies, but will be required to pay premiums. The Company's share of the estimated costs that will be paid after retirement is generally being accrued by charges to expense over the employees' active service periods to the dates they are fully eligible for benefits, except that the Company's unfunded cost that existed at January 1, 1993 is being accrued primarily in a straight-line manner that resulted in its full accrual by December 31, 2013.

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

The following amounts that have not been recognized in the net periodic benefit cost of the postretirement benefit plan for the year ended December 31, 2014 but are included in other comprehensive income: unrecognized net actuarial gain of \$38 thousand. The transition obligation included in other comprehensive income and expected to be recognized in the net periodic benefit cost of the postretirement benefit plan during 2015 is \$2 thousand.

The following tables provide a reconciliation of the changes in the benefit obligations and fair value of assets for 2014, 2013, and 2012 and a statement of the funded status at December 31, 2014, 2013 and 2012 for the postretirement benefit plans of the Company. The Company uses a December 31st measurement date for its plans.

	Postretirement Benefits Plan		
	2014	2013	2012
	(in thousands)		
Change in Benefit Obligation:			
Benefit obligation, beginning	\$ 138	\$ 150	\$ 150
Service cost	—	—	—
Interest cost	5	4	5
Actuarial loss (gain)	1	(9)	2
Benefits paid	(7)	(7)	(7)
Settlement loss	—	—	—
Benefit obligation, ending	<u>\$ 137</u>	<u>\$ 138</u>	<u>\$ 150</u>
Change in Plan Assets:			
Fair value of plan assets, beginning	\$ —	\$ —	\$ —
Actual return on plan assets	—	—	—
Employer contributions	7	7	7
Benefits paid	(7)	(7)	(7)
Fair value of plan assets, ending	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Postretirement Benefits Plan			
2014 2013 2012			
(in thousands)			
Funded Status:			
Funded status	\$ (137)	\$ (138)	\$ (150)
Unrecognized net actuarial loss	—	—	—
Unrecognized net transition obligation	—	—	—
Unrecognized prior service cost	—	—	—
Accrued benefits	<u>\$ (137)</u>	<u>\$ (138)</u>	<u>\$ (150)</u>
Amounts Recognized in Consolidated Balance Sheets:			
Prepaid benefit cost	\$ —	\$ —	\$ —
Accrued liability	(137)	(138)	(150)
	<u>\$ (137)</u>	<u>\$ (138)</u>	<u>\$ (150)</u>
Amounts Recognized in Accumulated Other Comprehensive Income:			
Net actuarial loss (gain)	\$ (57)	\$ (65)	\$ (65)
Net transition obligation	—	—	—
Deferred tax (benefit)/liability	19	21	21
	<u>\$ (38)</u>	<u>\$ (44)</u>	<u>\$ (44)</u>

The following tables provide the components of net periodic benefit cost of the postretirement benefit plan for the years ended December 31, 2014, 2013, and 2012:

	Postretirement Benefits Plan		
	2014	2013	2012
	(in thousands)		
Components of Net Periodic Benefit Cost:			
Service cost	\$ —	\$ —	\$ —
Interest cost	5	4	5
Expected return on plan assets	—	—	—
Amortization of prior service costs	—	—	—
Amortization of transition obligation	—	—	—
Recognized net loss due to settlement	—	—	—
Amortization of net actuarial loss	(9)	(7)	(8)
Net periodic benefit cost	<u>\$ (4)</u>	<u>\$ (3)</u>	<u>\$ (3)</u>

The benefit obligation for the postretirement benefit plan was calculated using a weighted average discount rate of 3.50% for 2014, 2.75% for 2013, and 3.50% for 2012. For measurement purposes, a 10.00% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2015 and 2016, 8.00% for 2017 and 2018, and 6.00% for 2019 and thereafter. If these rates were increased by 1.00% in each year, the benefit obligation at December 31, 2014 would have increased by \$6 thousand and the net periodic benefit cost for 2014 would have increased by less than \$1 thousand. If these rates were decreased by 1.00% in each year, the benefit obligation at December 31, 2014 would have decreased by \$5 thousand and the net periodic benefit cost for 2014 would have decreased by less than \$1 thousand.

Estimated future benefit payments at December 31, 2014, which reflect expected future service, as appropriate, were as follows:

	Postretirement Benefits
	(in thousands)
2015	\$ 13
2016	13
2017	13
2018	13
2019	13
2020 - 2024	54

NOTE 11. Stock-Based Compensation

The exercise price of stock options granted under this plan, both incentive and non-qualified, cannot be less than the fair market value of the common stock on the date that the option is granted. The maximum term for an option granted under this plan is ten years and options granted may be subject to a vesting schedule. All of the non-qualified stock options granted under the plan had a ten year term and were subject to a vesting period. The following table summarizes options outstanding at December 31, 2014, 2013, and 2012:

	2014			2013		2012	
	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	10,000	\$ 21.55		20,000	\$ 21.59	22,000	\$ 21.59
Granted	—	—		—	—	—	—
Exercised	(927)	21.55		(3,872)	21.63	—	—
Forfeited	(9,073)	21.55		(6,128)	21.63	(2,000)	21.59
Outstanding, end of year	<u>—</u>	\$ —		<u>10,000</u>	\$ 21.55	<u>20,000</u>	\$ 21.59
Exercisable, end of year	—	\$ —	\$ —	10,000	\$ 21.55	20,000	\$ 21.59
Weighted average fair value of options granted during the year		\$ —			\$ —		\$ —

The aggregate intrinsic value in the table is equal to the amount that would have been received by the option holders had all options been exercised on December 31, 2014. It is derived from the amount by which the current market value of the underlying stock exceeds the exercise price of the option. This amount fluctuates in relation to the market value of the Company's stock.

Restricted Stock provides grantees with rights to shares of common stock upon completion of a service period or achievement of Company performance measures. During the restriction period, all shares are considered outstanding and dividends are paid to the grantee. Outside directors are periodically granted restricted shares which vest over a period of less than six months. During 2014, executive officers were granted restricted shares which vest over a three year service period and restricted shares which vest based on meeting performance measures over a three year period. The following table presents the activity for Restricted Stock for the years ended December 31, 2014, 2013 and 2012:

	Twelve Months Ended					
	December 31,					
	2014		2013		2012	
Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	
Nonvested, beginning of period	17,050	\$ 19.92	16,500	\$ 16.53	13,700	\$ 16.11
Granted	14,900	23.50	14,900	22.06	14,500	17.87
Vested	(14,009)	20.75	(13,699)	18.30	(10,963)	17.79
Forfeited	(2,790)	22.11	(651)	16.75	(737)	16.25
Nonvested, end of period	<u>15,151</u>	\$ 22.27	<u>17,050</u>	\$ 19.92	<u>16,500</u>	\$ 16.53

The Company recognizes compensation expense over the restricted period. Compensation expense was \$290 thousand, \$305 thousand, and \$242 thousand during December 31, 2014, 2013, and 2012, respectively. The total grant date fair value of Restricted Stock which vested was \$291 thousand and \$251 thousand for the years ended December 31, 2014 and 2013, respectively. Unrecognized compensation cost related to unvested Restricted Stock was \$64 thousand at December 31, 2014. This amount is expected to be recognized over a weighted average period of one year.

NOTE 12. Employee Benefits

The Company has established an Employee Stock Ownership Plan (ESOP) to provide additional retirement benefits to substantially all employees. Contributions can be made to the Bank of Clarke County Employee Retirement Trust to be used to purchase the Company's common stock. There were no contributions in 2014, 2013, and 2012.

The Company sponsors a 401(k) savings plan under which eligible employees may defer a portion of salary on a pretax basis, subject to certain IRS limits. Prior to January 1, 2007, the Company matched 50 percent of employee contributions, on a maximum of six percent of salary deferred, with Company common stock or cash, as elected by each employee. The shares for this purpose are provided principally by the Company's employee stock ownership plan (ESOP), supplemented, as needed, by newly issued shares. In conjunction with amending the pension plan, the 401(k) plan was amended, effective January 1, 2007, to include a non-elective safe-harbor employer contribution and an age-weighted employer contribution. Each December 31st, qualifying employees will receive a non-elective safe-harbor contribution equal to three percent of their salary for that year. Also, each December 31st, qualifying employees will receive an additional contribution based on their age and years of service. The percentage of salary for the age-weighted contribution increases on both factors, age and years of service, with a minimum of one percent of salary and a maximum of ten percent of salary. Contributions under the plan amounted to \$927 thousand in 2014, \$888 thousand in 2013, and \$867 thousand in 2012.

The Company has established an Executive Supplemental Income Plan for certain key employees. Benefits are to be paid in monthly installments following retirement or death. The agreement provides that if employment is terminated for reasons other than death or disability prior to age 65, the amount of benefits could be reduced or forfeited. The executive supplemental income benefit liability was \$78 thousand and \$93 thousand at December 31, 2014 and 2013, respectively. The executive supplemental income benefit expense, based on the present value of the retirement benefits, was \$21 thousand in 2014, \$8 thousand in 2013, and \$16 thousand in 2012. The plan is unfunded; however, life insurance has been acquired on the lives of these employees in amounts sufficient to discharge the plan's obligations.

NOTE 13. Commitments and Contingencies

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

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

As a member of the Federal Reserve System, the Bank is required to maintain certain average reserve balances. These reserve balances include usable vault cash and amounts on deposit with the Federal Reserve Bank. For the final weekly reporting period in the years ended December 31, 2014 and 2013, the amount of daily average required balances were approximately \$1.1 million and \$960 thousand, respectively. In addition, the Bank was required to maintain a compensating balance on deposit with a correspondent bank in the amount of \$250 thousand at December 31, 2014 and 2013.

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

NOTE 14. Derivative Instruments and Hedging Activities**Interest Rate Swaps**

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

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

The following table summarizes the fair value of derivative instruments at December 31, 2014 and December 31, 2013:

	2014		2013	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
(dollars in thousands)				
Derivatives designated as hedging instruments under GAAP				
Interest rate swap contracts	Other Liabilities	\$ 289	Other Liabilities	\$ 434

The following tables present the effect of the derivative instrument on the Consolidated Balance Sheets at December 31, 2014 and 2013 and the Consolidated Statements of Income for December 31, 2014, 2013, and 2012:

Derivatives in GAAP Cash Flow Hedging Relationships	Year Ended					
	December 31,					
	Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion)		Location of Gain (Loss) Recognized in Income (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income (Ineffective Portion)		
	2014	2013		2014	2013	2012
(dollars in thousands)						
Interest rate swap contracts, net of tax	\$ 96	\$ 132	Not applicable	\$ —	\$ —	—

NOTE 15. Transactions with Directors and Officers

The Bank grants loans to and accepts deposits from its directors, principal officers and related parties of such persons during the ordinary course of business. The aggregate balance of loans to directors, principal officers and their related parties was \$10.9 million and \$11.2 million at December 31, 2014 and 2013, respectively. These balances reflect total principal additions of \$6.7 million and total principal payments of \$7.0 million. The aggregate balance of deposits from directors, principal officers and their related parties was \$9.3 million and \$10.2 million at December 31, 2014 and 2013, respectively.

NOTE 16. Capital Requirements

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that the Company and the Bank met all capital adequacy requirements to which they are subject at December 31, 2014 and 2013.

At December 31, 2014, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the tables. There are no conditions or events since the notification that management believes have changed the Bank's category.

The following table presents the Company's and the Bank's actual capital amounts and ratios at December 31, 2014 and 2013:

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(dollars in thousands)						
December 31, 2014:						
Total Capital to Risk Weighted Assets						
Consolidated	\$ 83,923	19.06%	\$ 35,222	8.00%	N/A	
Bank of Clarke County	\$ 80,035	18.24%	\$ 35,107	8.00%	\$ 43,883	10.00%
Tier 1 Capital to Risk Weighted Assets						
Consolidated	\$ 78,817	17.90%	\$ 17,611	4.00%	N/A	
Bank of Clarke County	\$ 74,929	17.07%	\$ 17,553	4.00%	\$ 26,330	6.00%
Tier 1 Capital to Average Assets						
Consolidated	\$ 78,817	12.86%	\$ 24,515	4.00%	N/A	
Bank of Clarke County	\$ 74,929	12.28%	\$ 24,416	4.00%	\$ 30,520	5.00%
December 31, 2013:						
Total Capital to Risk Weighted Assets						
Consolidated	\$ 78,426	18.42%	\$ 34,062	8.00%	N/A	
Bank of Clarke County	\$ 74,595	17.61%	\$ 33,879	8.00%	\$ 42,349	10.00%
Tier 1 Capital to Risk Weighted Assets						
Consolidated	\$ 73,101	17.17%	\$ 17,031	4.00%	N/A	
Bank of Clarke County	\$ 69,299	16.36%	\$ 16,940	4.00%	\$ 25,409	6.00%
Tier 1 Capital to Average Assets						
Consolidated	\$ 73,101	12.48%	\$ 23,435	4.00%	N/A	
Bank of Clarke County	\$ 69,299	11.89%	\$ 23,313	4.00%	\$ 29,141	5.00%

NOTE 17. Restrictions On Dividends, Loans and Advances

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

At December 31, 2014, the Bank's retained earnings available for the payment of dividends to the Company was \$18.3 million. Accordingly, \$58.1 million of the Company's equity in the net assets of the Bank was restricted at December 31, 2014. Funds available for loans or advances by the Bank to the Company amounted to \$1.1 million at December 31, 2014.

NOTE 18. Dividend Investment Plan

The Company has a Dividend Investment Plan, which allows participants' dividends to purchase additional shares of common stock at 95% of its fair market value on each dividend record date.

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

The Company, through its subsidiary bank, is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, unfunded commitments under lines of credit, and commercial and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Company's exposure to credit loss is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2014 and 2013, the following financial instruments were outstanding whose contract amounts represent credit risk:

	2014	2013
	(dollar in thousands)	
Commitments to extend credit	\$ 7,001	\$ 17,574
Unfunded commitments under lines of credit	86,588	81,049
Commercial and standby letters of credit	4,067	4,358

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

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

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in granting loans to customers. The Bank holds collateral supporting these commitments if it is deemed necessary. At December 31, 2014, none of the outstanding letters of credit were collateralized.

The Bank has cash accounts in other commercial banks. The amount on deposit in these banks at December 31, 2014 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$1.2 million.

NOTE 20. Trust Preferred Capital Notes

In September 2007, Eagle Financial Statutory Trust II (the "Trust II"), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On September 20, 2007, Trust II issued \$7.0 million of trust preferred securities and \$217 thousand in common equity. The principal asset of Trust II is \$7.2 million of the Company's junior subordinated debt securities with the same maturity and interest rate structures as the capital securities. The securities have a LIBOR-indexed floating rate of interest and the interest rate at December 31, 2014 was 1.86%. The securities have a mandatory redemption date of September 1, 2037, and were subject to varying call provisions beginning September 1, 2012.

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

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

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

NOTE 21. Quarterly Condensed Statements of Income - Unaudited

The Company's quarterly net income, net income per common share and dividends per common share during 2014 and 2013 are summarized as follows:

	2014 Quarter Ended			
	March 31	June 30	September 30	December 31
	(in thousands, except per share amounts)			
Total interest and dividend income	\$ 6,150	\$ 6,396	\$ 6,253	\$ 6,051
Net interest income after provision for loan losses	5,372	6,191	5,773	5,252
Noninterest income	1,351	1,560	1,473	2,222
Noninterest expenses	4,843	4,966	5,333	4,844
Income before income taxes	1,880	2,785	1,913	2,630
Net income	1,363	1,958	1,385	2,434
Net income per common share, basic	0.40	0.57	0.40	0.71
Net income per common share, diluted	0.40	0.57	0.40	0.70
Dividends per common share	0.19	0.19	0.19	0.20

	2013 Quarter Ended			
	March 31	June 30	September 30	December 31
	(in thousands, except per share amounts)			
Total interest and dividend income	\$ 6,278	\$ 6,223	\$ 6,294	\$ 6,241
Net interest income after provision for loan losses	5,192	5,199	5,667	6,393
Noninterest income	1,932	2,469	1,581	1,480
Noninterest expenses	4,583	4,952	5,172	5,660
Income before income taxes	2,541	2,716	2,076	2,213
Net income	1,803	2,001	1,505	1,849
Net income per common share, basic	0.54	0.59	0.44	0.54
Net income per common share, diluted	0.53	0.59	0.44	0.54
Dividends per common share	0.19	0.19	0.19	0.19

NOTE 22. Fair Value Measurements

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

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

- Level 1 Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

- Level 2 Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

- Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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

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

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

The following table presents balances of financial assets and liabilities measured at fair value on a recurring basis at December 31, 2014 and December 31, 2013:

	Fair Value Measurements at December 31, 2014			
	Balance as of December 31, 2014	Using		
		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	\$ 37,211	\$ —	\$ 37,211	\$ —
Mortgage-backed securities	15,779	—	15,779	—
Obligations of states and political subdivisions	40,410	—	40,410	—
Corporate securities	765	—	765	—
Equity securities:				
Bank preferred stock	—	—	—	—
Total assets at fair value	\$ 94,165	\$ —	\$ 94,165	\$ —
Liabilities:				
Interest rate swap	289	—	289	—
Total liabilities at fair value	\$ 289	\$ —	\$ 289	\$ —

	Fair Value Measurements at December 31, 2013			
	Balance as of December 31, 2013	Using		
		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	\$ 34,744	\$ —	\$ 34,744	\$ —
Mortgage-backed securities	15,197	—	15,197	—
Obligations of states and political subdivisions	43,116	—	43,116	—
Corporate securities	8,423	—	8,423	—
Equity securities:				
Bank preferred stock	1,118	1,118	—	—
Total assets at fair value	\$ 102,598	\$ 1,118	\$ 101,480	\$ —
Liabilities:				
Interest rate swap	434	—	434	—
Total liabilities at fair value	\$ 434	\$ —	\$ 434	\$ —

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

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

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

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

The following table displays quantitative information about Level 3 Fair Value Measurements for certain financial assets measured at fair value on a nonrecurring basis for December 31, 2014:

	Quantitative information about Level 3 Fair Value Measurements for			
		December 31, 2014		
Assets:	Valuation Technique(s)	Unobservable Input	Range	Weighted Average
Impaired loans	Discounted appraised value	Selling cost	11% - 60%	16%
Other real estate owned	Discounted appraised value	Selling cost	5% - 13%	9%

The following table summarizes the Company's financial and nonfinancial assets that were measured at fair value on a nonrecurring basis at December 31, 2014 and December 31, 2013:

	Balance as of December 31, 2014	Carrying value at December 31, 2014		
		Identical Assets	Observable Inputs	Unobservable Inputs
		(Level 1)	(Level 2)	(Level 3)
(in thousands)				
Financial Assets:				
Impaired loans	\$ 1,751	\$ —	\$ 1,494	\$ 257
Nonfinancial Assets:				
Other real estate owned	2,102	—	2,102	—
	Balance as of December 31, 2013	Carrying value at December 31, 2013		
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		(Level 1)	(Level 2)	(Level 3)
(in thousands)				
Financial Assets:				
Impaired loans	\$ 2,719	\$ —	\$ 1,312	\$ 1,407
Nonfinancial Assets:				
Other real estate owned	1,646	638	1,008	—

The changes in Level 3 financial assets measured at estimated fair value on a nonrecurring basis during the twelve months ended December 31, 2014 were as follows:

	Fair Value Measurements at December 31, 2014	
	Impaired Loans	Other Real Estate Owned
(in thousands)		
Balance - January 1, 2013	\$ 1,407	\$ —
Sales proceeds	—	—
Valuation allowance	—	—
(Loss) on disposition	—	—
Transfers into Level 3	1,740	488
Transfers out of Level 3	(2,890)	(488)
Total assets at fair value	\$ 257	\$ —

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

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

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

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

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 amount and fair value of the Company's financial instruments at December 31, 2014 and 2013 were as follows:

	Fair Value Measurements at December 31, 2014				Fair Value as of December 31, 2014
	Carrying Value as of December 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Using					
(in thousands)					
Financial Assets:					
Cash and short-term investments	\$ 34,564	\$ 34,564	\$ —	\$ —	\$ 34,564
Securities	94,165	—	94,165	—	94,165
Restricted Investments	2,808	—	2,808	—	2,808
Loans, net	464,740	—	470,524	257	470,781
Accrued interest receivable	1,703	—	1,703	—	1,703
Financial Liabilities:					
Deposits	\$ 503,816	\$ —	\$ 503,917	\$ —	\$ 503,917
Federal funds purchased and securities sold under agreements to repurchase	—	—	—	—	—
Federal Home Loan Bank advances	40,000	—	40,152	—	40,152
Trust preferred capital notes	7,217	—	7,217	—	7,217
Accrued interest payable	160	—	160	—	160
Interest rate swap contract	289	—	289	—	289

Fair Value Measurements at						
December 31, 2013						
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, 2013
	December 31, 2013	(Level 1)	(Level 2)	(Level 3)	(Level 3)	
(in thousands)						
Financial assets:						
Cash and short-term investments	\$ 14,243	\$ 14,243	\$ —	\$ —	\$ —	\$ 14,243
Securities	102,598	1,118	101,480	—	—	102,598
Restricted Investments	2,192	—	2,192	—	—	2,192
Loans, net	438,785	—	446,329	1,407	—	447,736
Accrued interest receivable	1,797	—	1,797	—	—	1,797
Financial liabilities:						
Deposits	\$ 487,587	\$ —	\$ 488,074	\$ —	\$ —	\$ 488,074
Federal funds purchased and securities sold under agreements to repurchase	—	—	—	—	—	—
Federal Home Loan Bank advances	22,250	—	22,214	—	—	22,214
Trust preferred capital notes	7,217	—	7,217	—	—	7,217
Accrued interest payable	165	—	165	—	—	165
Interest rate swap contract	434	—	434	—	—	434

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

NOTE 23. Change in Accumulated Other Comprehensive Income

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

Changes to accumulated other comprehensive income by components are shown in the following tables for the years ended December 31, 2014, 2013, and 2012:

	Twelve Months Ended											
	December 31,											
	2014				2013				2012			
	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Change in Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Change in Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total	Unrealized Gains and Losses on Available for Sale Securities	Change in Fair Value of Interest Rate Swap	Change in Benefit Obligations and Plan Assets for the Post Retirement Benefit Plan	Total
	(dollars in thousands)											
January 1	\$ 547	\$ (286)	\$ 44	\$ 305	\$ 3,822	\$ (418)	\$ 44	\$ 3,448	\$ 3,262	\$ (382)	\$ 51	\$ 2,931
Other comprehensive income (loss) before reclassifications	2,382	145	(8)	2,519	(4,497)	201	—	(4,296)	894	(55)	(11)	828
Reclassifications from other comprehensive income (loss)	(990)	—	—	(990)	(465)	—	—	(465)	(45)	—	—	(45)
Tax effect of current period changes	(473)	(49)	3	(519)	1,687	(69)	—	1,618	(289)	19	4	(266)
Current period changes net of taxes	919	96	(5)	1,010	(3,275)	132	—	(3,143)	560	(36)	(7)	517
December 31	\$ 1,466	\$ (190)	\$ 39	\$ 1,315	\$ 547	\$ (286)	\$ 44	\$ 305	\$ 3,822	\$ (418)	\$ 44	\$ 3,448

For the years ended December 31, 2014, 2013, and 2012, \$990 thousand, \$465 thousand, and \$45 thousand respectively, was reclassified out of comprehensive income and appeared as Gain on Sale of Securities in the Consolidated Statement of Income.

NOTE 24. Subsequent Events

The Company has evaluated events and transactions subsequent to December 31, 2014 through the date these financial statements were issued. Based on definitions and requirements of Generally Accepted Accounting Principles for "Subsequent Events", the Company has identified one event that requires disclosure in the financial statements.

On February 25, 2015, the Company entered into a 15 year, \$3.3 million contract to lease its fourteenth retail branch, located in Leesburg, Virginia. This branch is expected to open in the Spring of 2015. Refer to Note 6 for the total minimum rental commitment of this lease and all other operating leases commitments.

NOTE 25. Condensed Financial Information – Parent Company Only**EAGLE FINANCIAL SERVICES, INC.
(Parent Company Only)
Balance Sheets
December 31, 2014 and 2013
(dollars in thousands)**

	<u>2014</u>	<u>2013</u>
Assets		
Cash held in subsidiary bank	\$ 1,694	\$ 419
Due from banks	504	504
Securities available for sale	1,383	2,893
Investment in subsidiaries, at cost, plus undistributed net income	76,423	69,692
Other assets	661	575
Total assets	<u>\$ 80,665</u>	<u>\$ 74,083</u>
Liabilities and Shareholders' Equity		
Trust preferred capital notes	\$ 7,217	\$ 7,217
Other liabilities	316	460
Total liabilities	<u>\$ 7,533</u>	<u>\$ 7,677</u>
Shareholders' Equity		
Preferred stock	\$ —	\$ —
Common stock	8,621	8,482
Surplus	12,618	11,537
Retained earnings	50,578	46,082
Accumulated other comprehensive income	1,315	305
Total shareholders' equity	<u>\$ 73,132</u>	<u>\$ 66,406</u>
Total liabilities and shareholders' equity	<u>\$ 80,665</u>	<u>\$ 74,083</u>

EAGLE FINANCIAL SERVICES , INC.
(Parent Company Only)
Statements of Income
Years Ended December 31, 2014, 2013, and 2012
(dollars in thousands)

	2014	2013	2012
Income			
Dividends from subsidiary bank	\$ 1,550	\$ —	\$ 800
Interest and dividends on securities available for sale	183	98	257
Other income (loss)	283	40	38
Total income	<u>\$ 2,016</u>	<u>\$ 138</u>	<u>\$ 1,095</u>
Expenses			
Interest expense on borrowings	\$ 317	\$ 317	\$ 318
Other operating expenses	226	221	192
Total expenses	<u>\$ 543</u>	<u>\$ 538</u>	<u>\$ 510</u>
Income (loss) before income tax (benefit) and equity in undistributed net income of subsidiary bank	<u>\$ 1,473</u>	<u>\$ (400)</u>	<u>\$ 585</u>
Income Tax (Benefit)			
	(37)	(135)	(75)
Income (loss) before equity in undistributed net income of subsidiary bank	<u>\$ 1,510</u>	<u>\$ (265)</u>	<u>\$ 660</u>
Equity in Undistributed Net Income of Subsidiary Bank			
	<u>5,630</u>	<u>7,423</u>	<u>5,890</u>
Net income	<u>\$ 7,140</u>	<u>\$ 7,158</u>	<u>\$ 6,550</u>
Comprehensive income	<u>\$ 8,150</u>	<u>\$ 4,015</u>	<u>\$ 7,067</u>

EAGLE FINANCIAL SERVICES , INC.
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2014, 2013, and 2012
(dollars in thousands)

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Cash Flows from Operating Activities			
Net Income	\$ 7,140	\$ 7,158	\$ 6,550
Adjustments to reconcile net income to net cash provided by operating activities			
(Gain) on the sale of securities	(283)	—	—
Stock-based compensation expense	290	305	242
(Discount accretion) premium amortization on securities	—	(1)	(1)
Undistributed earnings of subsidiary bank	(5,630)	(7,423)	(5,890)
Changes in assets and liabilities:			
(Increase) decrease in other assets	(10)	138	30
Increase (decrease) in other liabilities	1	1	(2)
Net cash provided by operating activities	<u>\$ 1,508</u>	<u>\$ 178</u>	<u>\$ 929</u>
Cash Flows from Investing Activities			
Purchases of securities available for sale	\$ (761)	\$ (1,044)	\$ —
Proceeds from the sale of securities available for sale	1,865	—	—
Proceeds from maturities of securities available for sale	405	1,458	1,945
Net cash provided by investing activities	<u>\$ 1,509</u>	<u>\$ 414</u>	<u>\$ 1,945</u>
Cash Flows from Financing Activities			
Cash dividends paid	\$ (1,944)	\$ (1,909)	\$ (1,805)
Issuance of common stock, employee benefit plan	202	179	107
Stock options exercised	—	69	—
Net cash (used in) financing activities	<u>\$ (1,742)</u>	<u>\$ (1,661)</u>	<u>\$ (1,698)</u>
Increase (decrease) in cash	<u>\$ 1,275</u>	<u>\$ (1,069)</u>	<u>\$ 1,176</u>
Cash			
Beginning	\$ 923	\$ 1,992	\$ 816
Ending	<u>\$ 2,198</u>	<u>\$ 923</u>	<u>\$ 1,992</u>

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of December 31, 2014 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

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

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

Under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2014, using the *2013 Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded as of December 31, 2014, the Company's internal control over financial reporting is adequate and effective and meets the criteria of the *Internal Control – Integrated Framework*.

Management's assessment did not determine any material weaknesses within the Company's internal control structure. There were no changes in the Company's internal control over financial reporting during the Company's quarter ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executives Officers and Corporate Governance

The information required by Part III, Item 10. is incorporated herein by reference to the Proxy Statement for the 2015 Annual Meeting of Shareholders to be held May 20, 2015.

Item 11. Executive Compensation

The information required by Part III, Item 11. is incorporated herein by reference to the Proxy Statement for the 2015 Annual Meeting of Shareholders to be held May 20, 2015.

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

The information required by Part III, Item 12. is incorporated herein by reference to the Proxy Statement for the 2015 Annual Meeting of Shareholders to be held May 20, 2015.

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

The information required by Part III, Item 13. is incorporated herein by reference to the Proxy Statement for the 2015 Annual Meeting of Shareholders to be held May 20, 2015.

Item 14. Principal Accounting Fees and Services

The information required by Part III, Item 14. is incorporated herein by reference to the Proxy Statement for the 2015 Annual Meeting of Shareholders to be held May 20, 2015.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) Financial Statements

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

(a)(2) Financial Statement Schedules

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

(a)(3) Exhibits

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

Exhibit No.	Description
3.1	Articles of Incorporation of the Company, restated in electronic format only as of March 1, 2006 (incorporated herein by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K dated March 1, 2006).
3.2	Bylaws of the Company (incorporated herein by reference to Exhibit 3.2 of the Company's Registration Statement on Form S-4, Registration No. 33-43681).
10.1	Description of Executive Supplemental Income Plan (incorporated by reference to Exhibit 10.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 1996).*
10.2	Amended and Restated Employment Agreement of John R. Milleson (incorporated herein by reference to Exhibit 10.2 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.3	Amended and Restated Employment Agreement of James W. McCarty, Jr. (incorporated herein by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.4	Eagle Financial Services, Inc. Stock Incentive Plan (incorporated herein by reference to Exhibit 4.3 of the Company's Registration Statement on Form S-8, Registration No. 333-118319).*
10.5	Eagle Financial Services, Inc. 2014 Stock Incentive Plan, incorporated by reference to Exhibit A of the Proxy Statement for the Annual Meeting of Shareholders held on May 21, 2014, filed in April 21, 2014.
10.6	Amended and Restated Employment Agreement of John E. Hudson (incorporated herein by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.7	Amended and Restated Employment Agreement of Kaley P. Crosen (incorporated herein by reference to Exhibit 10.7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.8	Employment Agreement of Dale L. Fritts (incorporated herein by reference to Exhibit 10.8 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.9	Employment Agreement of Kathleen J. Chappell (incorporated herein by reference to Exhibit 10.9 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013).*
21.1	Subsidiaries of the Company.
23.1	Consent of Smith Elliott Kearns & Company, LLC.
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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

101 The following materials from the Eagle Financial Service, Inc. Annual Report on Form 10-K for the year ended December 31, 2014 formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) notes to Consolidated Financial Statements.

* Management contracts and compensatory plans and arrangements.

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

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

SIGNATURES

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

Eagle Financial Services, Inc.

By: /s/ JOHN R. MILLESON

John R. Milleson

President and Chief Executive Officer

Date: March 30, 2015

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 30, 2015.

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

EXHIBIT INDEX

Exhibit No.	Description
3.1	Articles of Incorporation of the Company, restated in electronic format only as of March 1, 2006 (incorporated herein by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K dated March 1, 2006).
3.2	Bylaws of the Company (incorporated herein by reference to Exhibit 3.2 of the Company's Registration Statement on Form S-4, Registration No. 33-43681).
10.1	Description of Executive Supplemental Income Plan (incorporated by reference to Exhibit 10.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 1996).*
10.2	Amended and Restated Employment Agreement of John R. Milleson (incorporated herein by reference to Exhibit 10.2 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.3	Amended and Restated Employment Agreement of James W. McCarty, Jr. (incorporated herein by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.4	Eagle Financial Services, Inc. Stock Incentive Plan (incorporated herein by reference to Exhibit 4.3 of the Company's Registration Statement on Form S-8, Registration No. 333-118319).*
10.5	Eagle Financial Services, Inc. 2014 Stock Incentive Plan, incorporated by reference to Exhibit A of the Proxy Statement for the Annual Meeting of Shareholders held on May 21, 2014, filed in April 21, 2014.
10.6	Amended and Restated Employment Agreement of John E. Hudson (incorporated herein by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.7	Amended and Restated Employment Agreement of Kaley P. Crosen (incorporated herein by reference to Exhibit 10.7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.8	Employment Agreement of Dale L. Fritts (incorporated herein by reference to Exhibit 10.8 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008).*
10.9	Employment Agreement of Kathleen J. Chappell (incorporated herein by reference to Exhibit 10.9 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013).*
21.1	Subsidiaries of the Company.
23.1	Consent of Smith Elliott Kearns & Company, LLC.
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 32.1 Certification by Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following materials from the Eagle Financial Service, Inc. Annual Report on Form 10-K for the year ended December 31, 2014 formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) notes to Consolidated Financial Statements.

* Management contracts and compensatory plans and arrangements.

EXHIBIT 21.1

SUBSIDIARIES OF THE COMPANY

Bank of Clarke County is a wholly-owned subsidiary of the Company. Bank of Clarke County is a Virginia banking corporation, headquartered in Berryville, Virginia within the County of Clarke.

Eagle Financial Statutory Trust II (the "Trust") is a wholly-owned subsidiary of the Company. This Trust was formed under the laws of the State of Delaware for the purpose of issuing redeemable capital securities.

EXHIBIT 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We hereby consent to the incorporation by reference in the previously filed Registration Statements on Form S-8 (No. 333-118319) and Form S-3 (No. 333-131877 and No. 333-172264) pertaining to Eagle Financial Services, Inc. and our report dated March 30, 2015 relating to the consolidated financial statements of Eagle Financial Services, Inc. included in this Form 10-K of Eagle Financial Services, Inc. for the year ended December 31, 2014.

/s/ SMITH ELLIOTT KEARNS & COMPANY, LLC
SMITH ELLIOTT KEARNS & COMPANY, LLC

Chambersburg, Pennsylvania
March 30, 2015

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

I, John R. Milleson, certify that:

1. I have reviewed this annual report on Form 10-K of Eagle Financial Services, Inc. for the year ended December 31, 2014;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 30, 2015

/S/ JOHN R. MILLESON

John R. Milleson

President and Chief Executive Officer

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

I, Kathleen J. Chappell, certify that:

1. I have reviewed this annual report on Form 10-K of Eagle Financial Services, Inc. for the year ended December 31, 2014;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 30, 2015

/S/ KATHLEEN J. CHAPPELL

Kathleen J. Chappell

Vice President and Chief Financial Officer

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE
SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report on Form 10-Q of Eagle Financial Services, Inc. (the “Company”) for the period ended December 31, 2014 to be filed with the Securities and Exchange Commission (the “Report”), the undersigned Chief Executive Officer and Chief Financial Officer of the Company hereby certify, pursuant to 18 U.S.C. Code Section 1350, as adopted pursuant to Code Section 906 of the Sarbanes-Oxley Act of 2002 that, to our knowledge:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/S/ JOHN R. MILLESON

John R. Milleson
President and Chief Executive Officer

/S/ KATHLEEN J. CHAPPELL

Kathleen J. Chappell
Vice President and Chief Financial Officer

Date: March 30, 2015